91-2045

No.——

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

R. GORDON DARBY; DARBY DEVELOPMENT COMPANY; DARBY REALTY COMPANY; DARBY MANAGEMENT COMPANY, INCORPORATED; MD INVESTMENT; PARKBROOK ACRES ASSOCIATES; and PARKBROOK DEVELOPERS,
Petitioners,

v.

JACK KEMP, SECRETARY OF HOUSING AND URBAN DEVELOPMENT; ARTHUR J. HILL, ASSISTANT SECRETARY FOR HOUSING/FHA COMMISSIONER; U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT; and UNITED STATES OF AMERICA,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Can a federal appeals court impose an exhaustion requirement as a "rule of judicial administration" notwithstanding Section 10(c) of the Administrative Procedure Act and thereby foreclose judicial review of final adverse agency action, based upon a litigant's failure to pursue a permissive administrative appeal that is not required by statute or agency regulation?

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PETITION FOR A WRIT OF CERTIORARI

Petitioners respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fourth Circuit, entered in the above-entitled proceeding on February 26, 1992.

OPINIONS BELOW

The opinion of the Court of Appeals for the Fourth Circuit is reported at 957 F.2d 145, and is reprinted in the appendix hereto, p. 1a, *infra*.

The memorandum decision of the United States District Court for the District of South Carolina (Norton, J.) has not been reported. It is reprinted in the appendix hereto, p. 20a, *infra*.

The initial decision and order of the Administrative Law Judge ("ALJ") of the United States Department of Housing and Urban Development ("HUD") has not been reported. It is reprinted in the appendix hereto, p. 33a, *infra*. The "final determination" of HUD debarring petitioners in accordance with the ALJ's initial decision and order likewise has not been reported. It is reprinted in the appendix hereto, p. 91a, *infra*.

JURISDICTION

Invoking federal jurisdiction under 28 U.S.C. §§ 1331, 1346, and 2201, petitioners brought this action in the District of South Carolina. On October 26, 1990, the district court denied a motion by the respondents to dismiss for failure to exhaust administrative remedies. On April 10, 1991, the district court granted petitioners' motion for summary judgment. (Appendix 8a).

On respondents' appeal, the Fourth Circuit on February 26, 1992, entered a judgment and an opinion reversing the district court's order of October 26, 1990, and directing that petitioners' complaint be dismissed for failure to exhaust administrative remedies. On March 20, 1992, the circuit court denied petitioner's petition for rehearing. (Appendix, p. 93a).

The jurisdiction of this Court to review the judgment of the Fourth Circuit is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

Section 10(c) of the Administrative Procedure Act, 5 U.S.C. § 704, entitled "Actions Reviewable," provides in pertinent part that:

> Except as otherwise expressly required by statute, agency action otherwise final is final for the purposes of this section whether or not there has been presented or determined any application for a declaratory order, for any form of reconsideration, or unless the agency otherwise requires by rule and provides that the action meanwhile is inoperative, for an appeal to superior agency authority.

STATEMENT OF THE CASE

HUD initiated administrative sanctions against petitioner Darby on June 19, 1989, by issuing a one-year Limited Denial of Participation ("LDP"). Mr. Darby contested the issuance of this LDP at an administrative conference, following which HUD affirmed the LDP by letter dated July 11, 1989. Mr. Darby then initiated an administrative appeal of the LDP on July 21, 1989.

By notice dated August 23, 1989, HUD's debarring official (the Assistant Secretary for Housing) proposed to debar all petitioners—Mr. Darby and his affiliates (hereafter, collectively, "Mr. Darby")[1]—from participating in all federal procurement and nonprocurement programs for a period of five years, based on the same underlying facts and circumstances that gave rise to the LDP. HUD subsequently filed a formal debarment complaint and Mr. Darby filed an answer. By letter dated November 16, 1989, the debarring official increased the length of the proposed debarments to an indefinite period.

The LDP appeal and the debarment action were consolidated for hearing before a HUD ALJ. A four-day

[1] Pursuant to Supreme Court Rule 29.1, petitioner states that there are no parent companies or subsidiaries of petitioners.

evidentiary hearing was conducted on December 19-22, 1989, in Charleston, South Carolina. Following the hearing, both parties filed briefs and the ALJ took the case under advisement.

On April 13, 1990, ten months after the administrative proceedings had commenced, the ALJ issued a 37-page decision and order upholding the LDP and concluding that Mr. Darby should be debarred for a period of 18 months. The ALJ's decision contained 20 pages of factual findings. Neither party sought discretionary intra-agency review of the ALJ's ruling pursuant to 24 C.F.R. § 24.314(c) which provides that:

> The hearing officer's determination shall be final unless . . . the Secretary . . . within 30 days of receipt of a request decides as a matter of discretion to review the finding of the hearing officer. . . . Any party may request such a review in writing within 15 days of receipt of the hearing officer's determination.

Significantly, as the Fourth Circuit concluded, this regulation "does not expressly mandate exhaustion of administrative remedies prior to filing suit." (pp. 6a-7a, *infra*). Moreover, it does not provide that the hearing officer's determination (or the administrative sanction) shall be inoperative while Secretarial review is pending. Since neither party petitioned for Secretarial review, the ALJ's decision and order became HUD's final agency action on April 29, 1990.[2]

[2] The HUD Secretary has delegated authority to the Assistant Secretary for Housing to act as the debarring official. 54 Fed. Reg. 4913 (Jan. 31, 1989). Although HUD's regulations, 24 C.F.R. § 24.314(g), require the debarring official to issue a formal "final determination" in a contested case, HUD originally took the position that no such determination was required or would be issued in this case. With the matter in this posture, petitioners filed suit in the district court on May 31, 1990, as discussed below. Three weeks later, and over two months after the ALJ's decision, HUD reversed its position and the Assistant Secretary belatedly issued a "final determination" on June 21, 1990, debarring plaintiffs in accordance with the ALJ's decision.

Meanwhile, HUD's sanctions had been in effect throughout the pendency of the administrative proceedings and ten months of the eighteen-month debarment had already elapsed.[3] At this point, having diligently but fruitlessly pursued his administrative remedies for almost an entire year, Mr. Darby turned to the district court for redress. He did so only after a full factual record had been created before the agency and after a detailed decision had been rendered by the agency—a decision that was final according to HUD's own regulations.

On May 31, 1990, Mr. Darby filed suit in the United States District Court for the District of South Carolina seeking a declaration that the administrative sanctions violated provisions of the Administrative Procedure Act ("APA"), 5 U.S.C. §§ 701-06, and due process rights guaranteed by the Fifth Amendment. Mr. Darby did not challenge the factual findings made by the HUD ALJ in the complaint.

Respondents moved to dismiss the suit for failure to exhaust administrative remedies on the basis that Mr. Darby had not petitioned for Secretarial review. The district court denied this motion in an order filed on October 26, 1990, concluding that there were

> several concerns which militate against a blind application of the [exhaustion] rule under the facts of this case. One concern is that a dismissal would leave the decision of the ALJ wholly unreviewed.

[3] Under HUD's debarment and suspension regulations, 24 C.F.R. Part 24, a LDP is effective immediately upon its issuance. 24 C.F.R. § 24.710(b). Furthermore, evidence that a cause for debarment may exist is itself a cause for suspension. 24 C.F.R. § 24.405(a)(2). Thus, as is standard practice in such cases, Mr. Darby was suspended for the duration of the debarment proceeding against him once HUD issued the notice of proposed debarment.

> Another more significant concern is that, under the facts of this case, the available remedy is inadequate. A final concern is that exhaustion of the final administrative remedy would have been futile under the facts of this case.

(p. 28a, *infra*).

The district court proceeded to consider the case on its merits and, on April 10, 1991, granted Mr. Darby's motion for summary judgment. The district court vacated the administrative sanctions based upon its conclusion that "the debarment in this case was not rationally connected to the factual findings of the ALJ, and was further in conflict with the prohibition against imposing debarment for punitive reasons." (p. 17a, *infra*).

On appeal to the Fourth Circuit, respondents challenged only the district court's ruling on exhaustion.[4] Respondents contended that 24 C.F.R. § 24.314(c) (1991) required Mr. Darby to seek Secretarial review as a prerequisite to filing suit in federal court.[5] The circuit court rejected this contention, holding that the regulation "does not expressly mandate exhaustion of administrative remedies prior to filing suit." (pp. 6a-7a, *infra*). Nonetheless, the Fourth Circuit held that, as a "rule of judicial

[4] Although respondents also noted an appeal of the district court's ultimate ruling that the debarment of Mr. Darby was arbitrary and unlawful, they did not pursue that issue in their brief or argument to the circuit court.

[5] It was undisputed that there is no other statutory or regulatory exhaustion provision applicable to this case. HUD's current debarment regulations, 24 C.F.R. Part 24, were promulgated pursuant to Executive Order Number 12549, 51 Fed. Reg. 6370 (1986), which authorized a government-wide system for nonprocurement debarment and suspension, and pursuant to 42 U.S.C. § 3535(d), the housekeeping provision which enables the HUD Secretary to delegate his functions, powers and duties, and to make such rules and regulations as may be necessary to carry out his functions, powers and duties. Neither the statute nor the Executive Order requires exhaustion of an intra-agency appeal or even addresses the issue.

administration," exhaustion is still required "even when a statute does not impose an explicit directive." (p. 4a, *infra*).

Proceeding from this premise, the circuit court ruled as follows:

> In the absence of a statutory requirement of exhaustion, the district court properly turned to the judicial doctrine of exhaustion of administrative remedies and to possible avoidance of the rule by application of its exceptions. Our review, however, reveals that the facts do not warrant application of the exceptions. Therefore, the district court improperly denied the Secretary's motion to dismiss. We reverse and remand with instruction to dismiss Darby's complaint for failure to exhaust administrative remedies.

(p. 7a, *infra*). The circuit court made no reference to Section 10(c) of the APA, although that statutory provision was prominently cited in petitioners' brief and during oral argument.

The Fourth Circuit's ruling left Mr. Darby without any recourse since the fifteen-day period in April 1990 during which he could have requested discretionary Secretarial review had long since passed. However, the circuit court was unperturbed by this result.

> Yet Darby, by strategic decision or otherwise, allowed the filing period to pass. He cannot now complain that the decision is unreviewable.

(p. 6a, *infra*).

Mr. Darby petitioned for rehearing on the grounds that the court's decision contravened Section 10(c) and was in conflict with the decisions of other circuits which follow that statutory mandate. However, the Fourth Circuit denied this petition without opinion on March 20, 1992.

REASONS FOR GRANTING THE WRIT

The Fourth Circuit has created a novel and insupportable "rule of judicial administration" that any possible administrative appeal must be exhausted before judicial review may be sought under the APA, even though such exhaustion is not required by relevant statutes or regulations. This ruling amounts to a judicial repeal of Section 10(c) of the APA, in which Congress explicitly provided that a litigant seeking judicial review of a final agency action *need not exhaust* available administrative appeals *unless* such exhaustion is *expressly required by statute or agency rule.*

In addition, the Fourth Circuit's decision conflicts with the opinions of the majority of federal courts that have addressed the issue, and exacerbates the disarray among the circuits about the proper application of the exhaustion doctrine and the impact of Section 10(c). Previously, two other circuits have indicated that, notwithstanding Section 10(c), a federal court has discretion to impose an exhaustion requirement and postpone judicial review. However, no other circuit has gone to the extreme that the Fourth Circuit did in this case, overriding Section 10(c) and depriving a litigant of judicial review in the process. Absent review and reversal by this Court, the Fourth Circuit's decision sets a pernicious precedent that will perpetrate further injustices in innumerable future cases.

Courts should not decline the exercise of jurisdiction under a federal statute pursuant to the exhaustion doctrine unless it is consistent with congressional intent. *Coit Indep. Joint Venture v. FSLIC*, 489 U.S. 561, 580 (1989). Indeed, federal courts "have no more right to decline the exercise of jurisdiction which is given, than to usurp that which is not given." *McCarthy v. Madigan*, —— U.S. ——, 112 S.Ct. 1081, 1087 (1992), citing *Cohens v. Virginia*, 19 U.S. (6 Wheat.) 264, 404 (1821). Accordingly, this Court has recently held, in a decision

issued after the Fourth Circuit's decision in this case, that:

> Where Congress specifically mandates, exhaustion is required. But where Congress has not clearly required exhaustion, sound judicial discretion governs. Nevertheless, even in this field of judicial discretion, appropriate deference to Congress' power to prescribe the basic procedural scheme under which a claim may be heard in a federal court requires fashioning of exhaustion principles in a manner consistent with congressional intent and any applicable statutory scheme.

McCarthy v. Madigan, —— U.S. at ——, 112 S.Ct. at 1087 (citations omitted).

I. THE FOURTH CIRCUIT'S DECISION DECIDES AN IMPORTANT FEDERAL QUESTION IN A WAY THAT PATENTLY VIOLATES THE ADMINISTRATIVE PROCEDURE ACT

In enacting the judicial review provisions of the APA, Congress dealt explicitly with the issue of exhaustion of administrative remedies. It provided in Section 10(c) that:

> Except as otherwise expressly required by statute, agency action otherwise final is final for the purposes of this section whether or not there has been presented or determined any application for a declaratory order, for any form of reconsideration, or unless the agency otherwise is inoperative, for an appeal to superior agency authority.

5 U.S.C. § 704. "[T]he primary thrust of § 704 was to codify the exhaustion requirement." *Bowen v. Massachusetts*, 487 U.S. 879, 903 (1988). The clear meaning of this provision is that exhaustion of intra-agency appeals is not a prerequisite to judicial review under the APA except to the extent that other statutes or appropriate agency rules command otherwise. *See* 4 Kenneth C. Davis, *Administrative Law Treatise* § 26:12, p. 470 (2d ed.

1983); *New England Coalition on Nuclear Pollution v. United States Nuclear Regulatory Comm'n*, 582 F.2d 87, 99 (1st Cir. 1978).

The legislative history of the APA leaves no doubt about this conclusion. While the legislation was pending before Congress, the Department of Justice submitted to both the Senate and House Committees on the Judiciary a detailed analysis of the statute. It summarized Section 10(c) in the following terms:

> Section 10(c): This subsection states (subject to the provisions of section 10(a)), the acts which are reviewable under section 10. It is intended to state existing law. *The last sentence makes it clear that the doctrine of exhaustion of administrative remedies with respect to finality of agency action is intended to be applicable only (1) where expressly required by statute (as, for example, is provided in 49 U.S.C. 17(9)), or (2) where the agency's rules require that decisions by subordinate officers must be appealed to superior agency authority before the decision may be regarded as final for purposes of judicial review.*

Administrative Procedure Act: Legislative History 79th Congress, 230 (1946) ("APA Leg. Hist.") (emphasis added); *see also Samuel B. Franklin & Co. v. SEC*, 290 F.2d 719, 724 (9th Cir.), *cert. denied*, 368 U.S. 889 (1961) (discussing this legislative history).

The Senate Judiciary Committee's report on the APA includes the following discussion of Section 10(c):

> The last clause, permitting agencies to *require by rule* that an appeal be taken to superior agency authority before judicial review may be sought, is designed to implement the provisions of section 8(a). Pursuant to that subsection an agency may permit an examiner to make the initial decision in a case, which becomes the agency's decision in the absence of an appeal to or review by the agency. If there is such review or appeal, the examiner's initial decision becomes inoperative until the agency determines the matter. For that reason *this subsection permits an agency* also *to require by rule that, if any party is not satisfied with the initial decision of a subordinate hearing officer, the party must first appeal to the agency (the decision meanwhile being inoperative) before resorting to the courts. In no case may appeal to "superior agency authority" be required by rule unless the administrative decision meanwhile is inoperative, because otherwise the effect of such a requirement would be to subject the party to the agency action and to repitious administrative process without recourse. There is a fundamental inconsistency in requiring a person to continue "exhausting" administrative processes after administrative action has become, and while it remains, effective.*

S. Rep. No. 752, 79th Cong., 1st Sess. (1945), *reprinted in* APA Leg. Hist. at 185, 213 (emphasis added). The House Judiciary Committee report contains a virtually identical description of Section 10(c). H. Rep. No. 1980, 79th Cong., 2d Sess. (1946), *reprinted in* APA Leg. Hist. at 233, 277.

Following the enactment of the APA, the Department of Justice prepared a manual analyzing the provisions of the Act as a guide to the federal agencies in adjusting their procedures to comport with the law. That manual discussed the import of Section 10(c) in the following terms:

> The last clause of section 10(c) permits an agency to require *by rule* that in such cases parties who are dissatisfied with the "initial" decisions of hearing officers must appeal to the agency before seeking judicial review, but only if the agency further provides that the hearing officers' decisions shall be inoperative pending such administrative appeals.

Attorney General's Manual on the Administrative Procedure Act 104-05 (1947) (emphasis in the original).

Thus, the logic and the command of Section 10(c) are clear and simple. On one hand, it freely permits an agency (by appropriate rule) or Congress (by statute) to require exhaustion of intra-agency appeals with respect to any particular administrative action. Conversely, absent the imposition of such a requirement, it provides a litigant aggrieved by a final agency decision with the right to seek immediate relief in federal court under the APA. The Fourth Circuit ignored the second half of this statutory mandate and divested the district court of jurisdiction in a situation where Congress has explicitly guaranteed litigants such as Mr. Darby judicial recourse from arbitrary and unjust administrative action.[6]

II. THE FOURTH CIRCUIT'S DECISION IS IN CONFLICT WITH CIRCUIT COURT DECISIONS ON THE SAME MATTER AND APPLICABLE DECISIONS OF THIS COURT

The Fourth Circuit's decision likewise conflicts with the opinions of the majority of federal courts that have addressed the issue presented here. Those courts have recognized that, for purposes of judicial review under the APA, Section 10(c) dispenses with any requirement to exhaust intra-agency appeals unless another statute or an appropriate agency rule commands otherwise. *New England Coalition on Nuclear Pollution v. United States Nuclear Regulatory Comm'n*, 582 F.2d 87, 99 (1st Cir. 1978); *Steere Tank Lines, Inc. v. ICC*, 675 F.2d 763, 766 (5th Cir. 1982) (citing *New England Coalition*); *Gulf Oil Corp. v. United States Dep't of Energy*, 663 F.2d 296, 308 n.73 (D.C. Cir. 1981) (citing *United States v. Consolidated Mines & Smelting Co.*, 445 F.2d 432 (9th

[6] Perhaps the most disquieting aspect of respondents' litigation posture in this case is that HUD easily could have imposed an exhaustion requirement by regulation, in conformance with Section 10(c). The agency having failed to do so, respondents importuned the Fourth Circuit to impose a judicial exhaustion requirement retroactively and in blatant contravention of Section 10(c).

Cir. 1971); *Mount Sinai Hosp. of Greater Miami v. Weinberger*, 376 F. Supp. 1099, 1124-25 (S.D. Fla. 1974), *rev'd on other grounds*, 517 F.2d 329 (5th Cir. 1975), *cert. denied*, 425 U.S. 935 (1976).

Furthermore, the Fourth Circuit's decision is inconsistent with this Court's decision in *ICC v. Brotherhood of Locomotive Engineers*, 482 U.S. 270, 284-85 (1987), which noted that:

> [Section 10(c)] has long been construed by this and other courts . . . to relieve parties from the *requirement* of petitioning for rehearing before seeking judicial review (unless, of course, specifically required to do so by statute—*see, e.g.*, 15 U.S.C. § 717r, 3416(a)). . . .

(emphasis in the original). Section 10(c) equates a petition "for any form of reconsideration" with "an appeal to superior agency authority" insofar as the need for exhaustion is concerned. The only distinction is that Section 10(c) permits an agency to require by rule an appeal to superior agency authority, whereas a petition for reconsideration or rehearing can only be a prerequisite to judicial review if expressly required by statute. Therefore, in the absence of a statutory or regulatory exhaustion requirement, Section 10(c) relieves parties from the obligation to pursue intra-agency appeals just as surely as it relieves them from the need to file petitions for rehearing.

Unfortunately, the Fourth Circuit's disregard of Section 10(c) cannot be dismissed as aberrational. Professor Davis, in his treatise, has decried the repeated occasions on which this statute has been ignored and violated by federal courts, thereby creating needless and detrimental complexity in the application of the exhaustion doctrine. 4 Kenneth C. Davis, *Administrative Law Treatise* § 26:12 (2d ed. 1983). This Court, in *Bowen v. Massachusetts*, 487 U.S. 879, 902 (1988), repeated Professor

Davis' complaint that Section 10(c) "has been almost completely ignored in judicial opinions." Although many judicial violations of Section 10(c) may have been unwitting, some courts have consciously disregarded it and others evidently are uncertain of its import with respect to application of the exhaustion doctrine.

The Ninth Circuit has explicitly asserted that a federal court may impose an exhaustion requirement notwithstanding Section 10(c). *Montgomery v. Rumsfeld*, 572 F.2d 250 (9th Cir. 1978). Iornically, that same court previously had ruled that Section 10(c) resolves the application of the exhaustion doctrine. *United States v. Consolidated Mines & Smelting Co.*, 455 F.2d 432, 440, 451-52 (9th Cir. 1971).[7] However, in *Montgomery v. Rumsfeld*, the Ninth Circuit retreated from its earlier decision and stated:

> There is language in *Consolidated Mines*, *supra*, 455 F.2d at 440, arguably suggesting that not only does section 10(c) not require the exhaustion of intra-agency appeals not mandated by statute or regulation, but that the courts are not free to impose such a requirement on their own . . . .
>
> Although this language might be read to preclude judicial insistence on exhaustion of administrative remedies when the statute or appropriate agency rules do not so insist, the courts have not considered themselves so limited.

572 F.2d at 253 n.3.

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[7] The *Consolidated Mines* decision garnered widespread scholarly praise for its treatment of the exhaustion issue. *See* Project, *Federal Administrative Law Developments—1971*, 1972 Duke L.J. 115, 298-99 (1972) (*Consolidated Mines* "has finally brought judicial application of the doctrine of exhaustion of administrative remedies into conformity with the mandate of section 10(c)."); 4 Kenneth C. Davis, *Administrative Law Treatise* § 26:12, p. 470 (2d ed. 1983) (describing *Consolidated Mines* as the "outstanding" example of a court discovering and following Section 10(c)).

This reasoning patently contravenes Section 10(c), although the Ninth Circuit's actual holding was less egregious than the Fourth Circuit's ruling in this case. The unexhausted administrative appeal at issue in *Montgomery v. Rumsfeld* evidently was still a live option for the plaintiffs. Furthermore, the Ninth Circuit suggested that the district court could retain jurisdiction of plaintiffs' suit pending the outcome of that administrative appeal. *Id.* at 253-54. Thus, the imposition of an exhaustion requirement merely postponed judicial review of the challenged agency action and did not, as here, operate to deprive the litigant of ultimate recourse to federal court and, indeed, of any remedy whatsoever.

Yet another circuit recently equivocated about the impact of Section 10(c) on judicial discretion to impose an exhaustion requirement. In *Missouri v. Bowen*, 813 F.2d 864 (8th Cir. 1987), the Eighth Circuit stated that, since neither the governing statutes nor regulations required exhaustion, application of the doctrine rested within the sound discretion of the district court. 813 F.2d at 871. The circuit court went on to uphold the district court's ruling that exhaustion was not required on the facts of that case. In a footnote, the Eighth Circuit added that "it appears that section 10(c) of the APA, in conjunction with the Supreme Court's 'flexible' approach to finality, indicate that an intra-agency appeal in this case was not required." 813 F.2d at 870-71 n.15. Thus, while recognizing the relevance of Section 10(c), the Eighth Circuit held that judicial discretion controls the resolution of the exhaustion issue and implied that Section 10(c) might be outweighed by other considerations.

It appears, however, that no other federal court has adopted the extreme position taken by the Fourth Circuit here—that, even in the absence of a statute or agency rule, exhaustion of all available administrative remedies is *always* required as a "rule of judicial admin-

istration" unless some exception to the exhaustion doctrine applies. Not only does this ruling conflict with Section 10(c) and with the decisions of other circuits applying that statute; it amounts to a wholesale overturning of the clear, simple and fair exhaustion provisions established by Congress in the statute.

III. THE FOURTH CIRCUIT'S RULE OF JUDICIAL ADMINISTRATION CREATES PERNICIOUS EFFECTS THAT CALL FOR EXERCISE OF THIS COURT'S POWER OF SUPERVISION

The Fourth Circuit has manufactured a "rule of judicial administration" that has virulent consequences for all sides. From the perspective of a person who is aggrieved by final adverse agency action, the Fourth Circuit's rule transforms the administrative appeal process into a prolonged gauntlet that must be run before judicial redress can be sought. Every possible administrative appeal must be pursued upon pain of losing the right to judicial review and perhaps forfeiting any recourse whatsoever. The attendant delays and expenditure of resources will cause many persons to give up before they can obtain judicial review and will, at a minimum, delay judicial review and relief for those litigants who do manage to stay the course. The Fourth Circuit's rule does precisely what Congress sought to proscribe by enacting Section 10(c)—it subjects the person to the agency action and to repetitious administrative process without recourse, thereby enshrining the "fundamental inconsistency" of requiring continued "exhaustion" after administrative action has become, and while it remains, effective.

That is not all. From the perspective of government counsel, the novel Fourth Circuit rule is a potent and tempting tactical weapon to wield in APA litigation, which will multiply procedural litigation and divert resources from focus on the merits of agency action. Indeed, it is a virtually ideal "sandbag" with which to

dispose of litigants altogether by raising the exhaustion issue in federal court after the time limit for any administrative appeal has expired. Likewise, from the agency's perspective, it removes all incentive to promuigate clear rules governing administrative appeals and the need for exhaustion; to the contrary, it creates an incentive for murky procedures that confuse parties and that can be selectively invoked to the agency's tactical advantage.

From the perspective of the district courts, this new rule will further complicate the resolution of exhaustion issues. Apart from the conflict with Section 10(c), it transforms the exhaustion doctrine from a matter of sound judicial discretion into a rigid "rule of judicial administration" with which district courts must comply upon pain of reversal. Furthermore, while the rule has a facial simplicitly, usually it will be far more difficult to apply than the standards established by Section 10(c). In many cases it may be unclear or debatable whether there exists an available administrative appeal that was not exhausted. What, for example, is the need to petition for rehearing or reconsideration? And, if the court concludes that an available appeal was not exhausted, then it must wrestle with the complexities of whether an exception to the exhaustion doctrine applies.

Equally deplorable is the confusion and error which the Fourth Circuit's decision is bound to generate among other federal courts in applying the exhaustion doctrine. It is a precedent directly at odds with the express will of Congress as articulated in Section 10(c) of the APA. It is, moreover, a precedent which derogates from the obligation of federal courts to exercise the jurisdiction given them and, in the case of the APA, to protect citizens from unlawful and abusive agency actions.

This Court has stressed repeatedly that congressional intent is of paramount importance to any exhaustion inquiry. Therefore, lower courts *must* require exhaustion where Congress so mandates and *may* require exhaustion

as a matter of sound judicial discretion where Congress has not spoken. *E.g.*, *McCarthy v. Madigan*, —— U.S. ——, 112 S.Ct. 1081, 1086 (1992). However, there is a corollary that is insufficiently understood and that now requires explicit attention from this Court, namely, that federal courts *may not* require exhaustion where Congress has expressed a contrary intent.

In particular, federal courts are not at liberty to impose exhaustion requirements which conflict with Section 10(c) of the APA. Section 10(c) has been overlooked by federal courts all too often, with this case being the most egregious example but far from the only one. The Fourth Circuit's application of a rule of judicial administration to bar judicial review of illegal agency action imposed against Mr. Darby works a terrible injustice. It is time for this Court to address and underscore the significance of that provision for the guidance of the lower courts and those litigants who appear before them.

CONCLUSION

For the foregoing reasons, this petition for certiorari should be granted.

Respectfully submitted,

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APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
FOURTH CIRCUIT

No. 91-2113

R. GORDON DARBY; DARBY DEVELOPMENT COMPANY; DARBY REALTY COMPANY; DARBY MANAGEMENT COMPANY, INCORPORATED; MD INVESTMENT; PARKBROOK ACRES ASSOCIATES; PARKBROOK DEVELOPERS,
Plaintiffs-Appellees,

v.

JACK KEMP, Secretary of Housing and Urban Development; C. AUSTIN FITTS, Assistant Secretary for Housing/FHA Commissioner; UNITED STATES OF AMERICA,
Defendants-Appellants.

Argued Oct. 31, 1991

Decided Feb. 26, 1992

Lori Marie Beranek, Civil Div., U.S. Dept. of Justice, Washington, D.C., argued, for defendants-appellants.

Steven D. Gordon, Dunnells, Duvall & Porter, Washington, D.C., argued (Stuart M. Gerson, Asst. Atty. Gen., Anthony J. Steinmeyer, Civil Div., U.S. Dept. of Justice, Washington, D.C., E. Bart Daniel, U.S. Atty., Michelle Z. Ligon, Asst. U.S. Atty., Marvin J. Caughman, Asst. U.S. Atty., Columbia, S.C., on brief), for plaintiffs-appellees.

Before PHILLIPS and WILKINS, Circuit Judges, and WARD, Senior District Judge for the Middle District of North Carolina, sitting by designation.

OPINION

WILKINS, Circuit Judge:

The Secretary of Housing and Urban Development appeals an order of the district court denying his motion to dismiss R. Gordon Darby's claim that the Secretary improperly debarred him from entering into various transactions with all executive branch agencies. The Secretary asserts that Darby's failure to exhaust the available remedies precludes his filing this action in federal court. We agree. Consequently, we reverse and remand.

I.

In mid-1982, Darby and his real estate development companies (Darby) began to finance, build and develop multi-family housing projects in South Carolina using single-family mortgage insurance programs offered by the United States Department of Housing and Urban Development (HUD). Darby's financing method evaded HUD limitations on minimum investment requirements and the number of mortgages issued to a single borrower. After an investigation, HUD concluded that the financing method violated various regulations and issued a Limited Denial of Participation (LDP) that prohibited Darby from taking part in HUD programs in South Carolina for one year. The Assistant Secretary for Housing and Urban Development proposed to debar Darby indefinitely after HUD learned that Darby used the same financing method to obtain permanent financing for other housing developments.

Pursuant to HUD regulations, Darby challenged the LDP and the debarment before an Administrative Law Judge (ALJ). *See* 24 C.F.R. § 24.313 (1991). On April

13, 1990, after a four-day hearing, the ALJ issued an order that upheld the LDP but reduced the indefinite debarment to eighteen months. Neither Darby nor the Secretary sought agency review of this decision. On May 31, 1990, Darby brought this action in district court seeking a declaration that the LDP and debarment violated provisions of the Administrative Procedure Act, *see* 5 U.S.C.A. §§ 551-59, 701-06 (West 1977 & Supp.1991), and due process rights guaranteed by the Fifth Amendment, U.S. Const. amend. V, cl. 4.

The district court denied a motion by the Secretary to dismiss for failure to exhaust administrative remedies. The court concluded that the applicable regulation did not contain an explicit exhaustion requirement. Although recognizing that exhaustion is generally required, the court determined that exceptions to the exhaustion rule applied. Specifically, it held that exhaustion would have been futile and that the available administrative remedies would have been insufficient. Further, the court determined that to require exhaustion would have shielded the ALJ's order from scrutiny. The court therefore excused Darby from exhausting his administrative remedies prior to seeking judicial review. The Secretary appeals the denial of the motion to dismiss.

II.

Relying on *Holcomb v. Colony Bay Coal Co.*, 852 F.2d 792 (4th Cir.1988), the Secretary contends that 24 C.F.R. § 24.-314(c) (1991) imposes a mandatory exhaustion requirement. This section provides:

> The hearing officer's determination shall be final unless . . . the Secretary . . . within 30 days of receipt of a request decides as a matter of discretion to review the finding of the hearing officer. The 30 day period for deciding whether to review a determination may be extended upon written notice of such extension by the Secretary or his designee. *Any party*

may request such a review in writing within 15 days of receipt of the hearing officer's determination.

Id. (emphasis added). Darby argues that the district court properly concluded that the regulation does not prescribe a requirement of exhaustion.

In *Holcomb*, this court examined a virtually identical regulation which provided that a party adversely affected by an ALJ's decision " 'may file with the [Federal Mine Safety and Health Review] Commission a petition for discretionary review within 30 days after issuance of the order or decision.' " *Holcomb*, 852 F.2d at 795 (quoting 29 C.F.R. § 2700.70(a) (1987)). We held that the claimant was required to exhaust administrative remedies prior to seeking judicial review. We read *Holcomb* as an application of the rule of judicial administration that even when a statute does not impose an explicit directive, exhaustion is still required. It is a " 'long settled rule of judicial administration that no one is entitled to judicial relief for a supposed or threatened injury until the prescribed administrative remedy has been exhausted.' " *Thetford Properties IV Ltd. P'ship v. United States Dep't of Hous. & Urban Dev.*, 907 F.2d 445, 448 (4th Cir. 1990) (quoting *Myers v. Bethlehem Shipbuilding Corp.*, 303 *U.S.* 41, 50-51, 58 S.Ct. 459, 463, 82 L.Ed.638 (1938)). The exhaustion doctrine allows an agency to exercise its discretion and apply its expertise, ensures autonomy, and avoids premature intervention by the courts. *See McKart v. United States*, 395 U.S. 185, 193-94, 89 S.Ct. 1657, 1662, 23 L.Ed.2d 194 (1969). It also "allow[s] the courts to have [the] benefit of an agency's talents through a fully developed administrative record." *Thetford Properties IV Ltd. P'ship*, 907 F.2d at 448.

III.

This conclusion, however, does not end our inquiry. The rule of exhaustion is, however, "like most judicial doctrines, subject to numerous exceptions." *McKart*, 395 U.S. at 193, 89 S.Ct. at 1662. These exceptions include futility of administrative review, *see Honig v. Doe*, 484 U.S. 305, 326-27, 108 S.Ct. 592, 605-06, 98 L.Ed.2d 686 (1988), and inadequacy of administrative remedies, *see Coit Indep. Joint Venture v. Federal Savs. and Loan Ins. Corp.*, 489 U.S. 561, 587, 109 S.Ct. 1361, 1375, 103 L.Ed. 2d 602 (1989). Further exhaustion may be excused if its application would leave an administrative decision unreviewed. *Cf. McGee v. United States*, 402 U.S. 479, 484, 91 S.Ct. 1565, 1568, 29 L.Ed.2d 47 (1971).

Although the district court applied the exceptions, we conclude that Darby did not meet his burden to come forward with evidence to excuse him from exhausting his administrative remedies. First, Darby maintains that further administrative review would have been futile because the upper echelons of HUD had endorsed debarment for Darby from the onset of the investigation. However, the record offers no indication that HUD had "taken a hard and fast position that [made] an adverse ruling a certainty." *Thetford Properties IV Ltd. P'ship*, 907 F.2d at 450; *cf. Sweet Life v. Dole*, 876 F.2d 402, 409 (5th Cir. 1989) (When the record did not indicate that review would not have been substantive, the court rejected an argument of futility.). To excuse exhaustion based on an "unsupported allegation of futility would allow the futility exception to swallow the exhaustion rule." *Thetford Properties IV Ltd. P'ship*, 907 F.2d at 450.

Second, the district court deemed section 24.314(c) an inadequate administrative remedy because of the latitude given to the Secretary to extend the time limits within which to issue a decision. Pursuant to section 24.314(c), the Secretary has a 30-day period coupled with a provision granting him discretion to extend this period to review the hearing officer's determination. If the Secretary grants review, he must render a decision within 30 days, again subject to his discretion to extend the time period. 24 C.F.R. § 24.314(e) (1991). The district court

determined that the time limits imposed by sections 24.314(c) and 24.314(e) rested between those the Supreme Court held inadequate in *Coit Independence Joint Venture*, 489 U.S. 561, 109 S.Ct. 1361, and those this court held adequate in *Thetford Properties IV Ltd.*, 907 F.2d 445. In *Coit Independence Joint Venture*, the Supreme Court held that the FSLIC process for adjudicating claims was inadequate because the regulations failed to place well-defined time limits on agency actions. This court, in *Thetford Properties IV Ltd.*, determined that HUD regulations providing a 180-day period for notification and approval of plans "demand[ed] prompt processing" and, therefore, survived *Coit Independence Joint Venture. Thetford Properties IV Ltd. P'ship*, 907 F.2d at 449. The district court held that "[a]lthough the administrative process available in this case is not as flawed as that in *Coit*, it is also not as prompt and effective as that found to be adequate in *Thetford*." We conclude that these time limitations provide an adequate administrative remedy in the absence of a showing that the Secretary has failed, or will fail, to act within a reasonable period of time. *Cf. Coit Indep. Joint Venture*, 489 U.S. at 586-87, 109 S.Ct. at 1375 (exhaustion excused because regulations established no time limit for review of claims). Moreover, because Darby did not attempt to exhaust his administrative remedies, it is speculative to suggest that the Secretary would have abused his discretion had he been given the opportunity to exercise it.

Third, the district court determined that application of the exhaustion requirement would bar judicial review of the ALJ's decision because the fifteen-day period during which Darby could have requested a review had passed. Yet Darby, by strategic decision or otherwise, allowed the filing period to pass. He cannot now complain that the decision is unreviewable.

We hold that section 24.314(c) does not expressly mandate exhaustion of administrative remedies prior to filing

suit. In the absence of a statutory requirement of exhaustion, the district court properly turned to the judicial doctrine of exhaustion of administrative remedies and to possible avoidance of the rule by application of its exceptions. Our review, however, reveals that the facts do not warrant application of the exceptions. Therefore, the district court improperly denied the Secretary's motion to dismiss. We reverse and remand with instructions to dismiss Darby's complaint for failure to exhaust administrative remedies.

REVERSED AND REMANDED.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF SOUTH CAROLINA
CHARLESTON DIVISION

C.A. #2:90-1184-18

R. GORDON DARBY,
DARBY DEVELOPMENT COMPANY,
DARBY REALTY COMPANY,
DARBY MANAGEMENT COMPANY, INC.,
MD INVESTMENT,
PARKBROOK ACRES ASSOCIATES, and
PARKBROOK DEVELOPERS,

Plaintiffs,

vs.

HONORABLE JACK KEMP
Secretary of U. S. Department
of Housing and Urban Development
451 7th Street, S.W.
Room No. 10000
Washington, D.C. 20410,

C. AUSTIN FITTS, Assistant
Secretary for Housing/FHA
Commissioner
451 7th Street, S.W.
Room No. 9100
Washington, D.C. 20410,

and

THE UNITED STATES OF AMERICA,

Defendants.

ORDER

[Filed Apr. 8, 1991—Entered Apr. 10, 1991]

This matter is before the Court on cross summary judgment motions of the parties. Oral argument on the motions was heard on December 18, 1990. After considering the oral arguments, motions, memoranda, and other material of record, this Court finds, for reasons discussed more fully below, that summary judgment in favor of the plaintiffs is granted, such that the April 13, 1990 Order of the Administrative Law Judge is reversed.

FACTUAL BACKGROUND

Plaintiff Robert Gordon Darby ("Mr. Darby") is a well-respected self-employed real estate developer who conducts business in South Carolina. In 1977, he formed the Darby Development Company, and began developing and managing multi-family rental projects through the company. To obtain financing for his multi-family projects, Mr. Darby consulted Lonnie Garvin, Jr. ("Mr. Garvin"), a mortgage banker from South Carolina.

Mr. Garvin's company, the Mid-South Financing Company, was established in 1976. Shortly after its establishment, Mid-South became a Housing and Urban Development ("HUD") approved mortgagee concentrating in HUD multi-family rental insurance programs. In early 1981, Mr. Garvin originated a financing plan (the "Mid-South Financing Plan") to enable multi-family developments to use the single family mortgage insurance program to finance the construction of rental units on existing lots. Although the following description is somewhat simplified,[1] the Mid-South Financing Plan worked in the following manner. The person seeking financing used

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[1] A more detailed description of the intricate workings of the financing plan can be found in the April 13, 1990 Order of the Administrative Law Judge.

straw purchasers as mortgage insurance applicants. The straw purchasers were actually Mid-South employees. Once the loans were closed, the straw purchasers would then transfer title back to the development company or to a syndicated limited partnership. The purpose for the use of the straw purchasers was to ensure technical compliance with the "Rule of Seven", 24 C. F. R. § 203.42. The "Rule of Seven" is a HUD regulation that makes rental properties ineligible for single family insurance if the mortgagor already has financial interests in seven or more similar rental properties in the same project or subdivision.[2] The "Rule of Seven" is designed to prevent mass default on single family loans.

In mid-1981, after devising the Mid-South Financing Plan, Mr. Garvin contacted the HUD Columbia office to determine whether the application of the "Rule of Seven" would be satisfied by dividing up the units so that any particular borrower would have no more than seven units at the time of the loan closing. At that time, Mr. Garvin learned from HUD employees Henry Granat, Deputy Director for Housing Development, and Robert DesChamps, Chief of the Mortgage Credit Bureau, that the Mid-South Financing Plan would not violate the "Rule of 7". Thereafter, Mid-South prepared applications for firm commitments and Mr. Garvin again met with Mr. DesChamps and Mr. Granat. This meeting occurred in November of 1981. At the meeting, Mr. Garvin more fully outlined the elements of the Mid-South Financing Plan. Mr. DesChamps, at the direction of Mr. Granat and in the presence of Mr. Garvin, called HUD Headquarters in Washington, D. C. and spoke with Ruth Studer, a HUD employee in the Headquarters Single

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[2] *See* 24 C.F.R. § 203.42 (a), which provides that applicants are not entitled to mortgage insurance if, at the time of the application, the property involved was "part of, or adjacent or contiguous to a project, subdivision or group of similar rental properties which involve eight or more dwelling units if the mortgagor or principals have any financial interest in such properties."

Family Division, Mortgage Credit Section. Ms. Studer was the "point person" for dealing with questions in this area. Based upon the description she was given over the telephone, she advised that the HUD requirements would not be violated by the financing plan.[3]

Although various HUD employees in Columbia knew of the financing method, they only slowly became aware of the extent to which it was being used by Mid-South. This was largely due to the lack of a tracking system which could match the volume of applications for units with the locations of these units. At some point in 1983, an on-site visit by HUD representatives resulted in the realization of the extent and location of the rental projects being financed by Mid-South under the single family mortgage insurance program.

Consequently, Mr. Granat asked his employees to review the propriety of their approval of these applications and was assured that everything was in order. However, to double-check, Mr. DesChamps again contacted Ms. Studer on March 30, 1983.[4] At this time Mr. DesChamps explained to Ms. Studer, in greater detail, the actual mechanism of the Mid-South Financing Plan. Ms. Studer again raised no objections to the process.

In the spring of 1983, HUD Columbia office employees brought to the attention of the office head, Franklin H. Corley, Jr., the volume of units being generated by Mid-South. At about the same time, another builder asked permission to use the Mid-South financing method for its

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[3] Ms. Studer is now retired, and does not remember this conversation. However, she testified that she received approximately 30 questions relating to the "Rule of Seven" per week and that she would have said it would be consistent with HUD rules for an individual who had obtained FHA loans on seven units to sell or transfer the properties and come back for seven more as long as there was no continuing financial interest held by the seller.

[4] Ms. Studer has no independent recollection of this conversation either.

properties. Mr. Corley orally advised the builder that he could use the Mid-South program because HUD Columbia had permission from Washington to use this type of plan. Shortly thereafter, the builder informed Mr. Corley that his attorney had advised him not to participate in such a financing arrangement because it was a violation of the multi-family rules and regulations.

Mr. Corley then asked his staff to prepare a memorandum summarizing the Mid-South Financing Plan. This memorandum was sent to Phillip Abrams, Acting Assistant Secretary for Housing/FHA Commissioner. The memorandum described the financing agreement as a proposal and did not make clear or in any way allude to the fact that this proposed agreement had in fact been used on over a thousand occasions.[5]

Mr. Abrams' reply, dated September 23, 1983, stated that the proposal would be unacceptable. The reply further noted that the plan was a vehicle to circumvent the regulations limiting the number of closely located rental units in which the same mortgagor may have a financial interest (the "Rule of Seven").

Thereafter, Mr. Darby's loans went into default, despite what the ALJ termed as "Herculean efforts" on the part of Mr. Darby to resolve the problems and save the projects from financial downfall. In fact, due to circumstances beyond the control of Mr. Darby and Mr. Garvin, virtually all of the mortgage loans obtained through the Mid-South Financing Plan, including Mr. Darby's loans, went into default and HUD ultimately was required to pay substantial insurance on the defaulted loans. Naturally, this led to an investigation of the Mid-South Financing Plan.

[5] It is significant to note however, that of this large number of transactions, only a small percentage were attributable to Mr. Darby's company. In actuality, use of the plan by Mr. Darby's company was minor, and Mr. Darby was not a major participant in the overall scheme.

A HUD audit of the loan transactions was initiated and conducted in the fall of 1986 to discover if there had been any wrongdoing. That audit report concluded that there was no wrongdoing on the part of either Mr. Garvin or Mr. Darby and that neither the HUD Columbia Office nor HUD Headquarters had been misled in any way. Additionally, the United States Attorney declined to pursue a criminal prosecution because the evidence did not support an intent on the part of Mr. Darby or Mr. Garvin to commit a crime.

Inexplicably, on June 19, 1989, HUD, through the manager of its Columbia, South Carolina office, issued plaintiffs a notice of limited denial of participation ("LDP") for a period of one year.[6] On July 21, 1989, plaintiffs filed an appeal from the issuance of the LDP.

On August 23, 1989, HUD's Assistant Secretary notified the plaintiffs of a proposed debarment. On August 28, 1989, the Assistant Secretary for Housing filed a formal complaint requesting debarment for an indefinite period. The plaintiffs appealed from the proposed debarment.

The appeal from the LDP was consolidated with the appeal from the proposed debarment and an extensive hearing was held in Charleston, South Carolina, from December 19 to December 22, 1989. On April 13, 1990, the ALJ issued his order in which he found that good cause existed to debar Mr. Darby and his affiliates for a period of 18 months, beginning on June 19, 1989, the date the LDP was imposed.[7] The debarment was effective throughout all agencies in the executive branch and

[6] The basis for the issuance of the LDP and subsequent debarment are discussed more fully below. *See* "Factual Background."

[7] Notably, this measure of punishment far exceeded that which was given to these employees of HUD who also had a role in the downfall of the single family program as a result of their erroneous approval of the Garvin program.

prevented plaintiffs from providing services as a contractor to those agencies and from participating in any federal nonprocurement programs. The ALJ also found adequate evidence to uphold the issuance of the LDP. The LDP expired on June 19, 1990. The debarment expired on December 20, 1990.[8]

On May 31, 1990 plaintiffs filed a complaint for declaratory and injunctive relief from the Order of the ALJ. Also on May 31, 1990, plaintiffs filed a motion for a preliminary injunction. The motion for a preliminary injunction sought an order restraining defendants from taking further action to implement the debarment until final adjudication of the complaint for declaratory and injunctive relief. This motion was opposed by the defendants.

On July 7, 1990, defendants filed a motion to dismiss the plaintiffs' complaint for declaratory and injunctive relief. The basis of this motion to dismiss was defendants' assertion that the plaintiffs failed to exhaust their administrative remedies with HUD prior to proceeding on the complaint for declaratory and injunctive relief.

After hearing oral argument and reviewing the briefs, record of the ALJ, and other exhibits, this Court issued an Order dated October 26, 1990, in which it denied both the plaintiffs' Motion for a Preliminary Injunction and the defendants' Motion to Dismiss.

On December 18, 1990, oral argument on the summary judgment motions filed by both parties was heard. Both parties agreed to submit this matter for adjudication in the summary judgment form, relying on the record presently before the Court.

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[8] Although the debarment has expired, this Court conducts its review because the "prospect of a lingering stigma or other adverse impact appears to keep this case vital." *See Caiola v. Carroll*, 851 F.2d 395, 401 (D.C.Cir. 1988).

SCOPE OF REVIEW

Section 706(2) of Title 5 of the United States Code provides that a court sitting in review of an agency determination shall

> hold unlawful and set aside agency action, findings, and conclusions found to be—
>
> (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;
>
> (E) unsupported by substantial evidence.

The distinction between the arbitrary and capricious standard, and the substantial evidence standard "has been described as 'largely semantic.'" *Caiola v. Carroll*, 351 F.2d 395, 398 (D.C. Cir. 1988), citing *Data Processing Serv. Orgs., Inc. v. Board of Governors of the Fed. Reserve Sys*, 745 F.2d 677, 683-84 (D.C.Cir. 1984). As a practical matter, under either standard, the question is whether there is a rational connection between the facts found and the choice made. *Bowman Transportation v. Arkansas-Best Freight*, 419 U.S. 281, 285 (1974); *Bowman Truck Lines v. U.S.*, 371 U.S. 156 (1962); *Caiola* at 398. Although this standard of review may be a narrow one, in employing the standard, "a court does not rubber stamp the action of the agency." *Port of Jacksonville Maritime Ad Hoc Committee, Inc. v. U.S. Coast Guard*, 788 F.2d 705, 708 (11th Cir. 1986).

While this Court must give the apporpriate level of deference to agency factfinding in reviewing an administrative adjudication, it determines *de novo* any questions of law. *First National Bank in Sioux Falls v. National Bank of South Dakota*, 667 F.2d 708, 711 (8th Cir. 1981). Whether an agency properly evaluated the evidence under the governing legal standard is an issue of law receiving plenary review. *Brooms v. U.S. Dept. of Labor*, 870 F.2d 95, 99 (3d Cir. 1989).

A court is always hesitant to reverse an agency decision, especially given the deferential standard of review applicable in such cases. However, in an appropriate case such as this, where this Court is unable to ascertain a rational connection between the facts established and the choice made, and where such irrationality leads to a conclusion that a sanction improper under the law was imposed, it feels compelled to reverse the decision of the ALJ.

DISCUSSION

The appropriate starting point for this Court's review is a recap of the ALJ's reasons for imposing debarment. It is upon examination of these reasons that it becomes apparent that there was simply no rational connection between the factual findings and the sanction chosen.

As noted in the factual findings above, this case arose out of a HUD related program in which Mr. Darby, through his company, was a participant. The ALJ first found that Mr. Darby "demonstrated a lack of forthrightness in his dealings with the government" and that "the Department demonstrated by preponderant evidence that [Mr. Darby] [lacked] present responsibility. (ALJ Order, p. 30). Additionally, the ALJ found that "debarment [would] serve to deter both [Mr. Darby] and others from taking similar actions." (ALJ Order, p. 30).

In assessing Mr. Darby's conduct, the ALJ then found "no evidence of any intent to deceive the Department," and that Mr. Darby "did not defraud the government." (ALJ Order, p. 36). Immediately after making these findings, the ALJ recognized that a debarment of three years would "serve no legitimate purpose and would be punitive." (ALJ Order, p. 36).

The ALJ went on the conclude that Mr. Darby "genuinely cooperated with HUD to work out his finanical dilemma and avoid foreclosure," and that "his efforts in this regard were herculean and beyond reproach." (ALJ

Order, p. 36). The ALJ recognized Mr. Darby's "reputation for truth and veracity among reputable lenders in the community and of his exemplary performance as a builder and manager of housing projects." Despite all of this, the ALJ inconceivably concluded that "a debarment for a meaningful period [was] necessary to deter [Mr. Darby] and others from acting similarly in the future." (ALJ Order, p. 36). In conclusion, the ALJ determined that "[a] debarment of some length is warranted to impress upon Respondent that he must act prudently when dealing with the government and to send a message to those who deal with the government that they, too, must act prudently in similar circumstances." After setting forth these reasons, the ALJ in his "Conclusion and Order" factored in the public interest stating that "[u]pon consideration of the public interest, and the entire record in this matter, I conclude that good cause exists to debar. . . ." (ALJ Order, p. 37).

Although this Court has read and reread the ALJ's order, the nagging inconsistencies in these factual findings have forced upon it one conclusion—that in the final analysis, the debarment in this case was not rationally connected to the factual findings of the ALJ, and was further in conflict with the prohibition against imposing debarment for punitive reasons. The lack of a rational connection contributes significantly to this Court's determination that the overall effect was punitive in nature. As explained below, this type of punitive motive is impermissive in a debarment scheme.

HUD's authority to debar or otherwise sanction program participants derives from and is governed by its debarment regulations, set forth at 24 C.F.R. § 24.100 *et seq.* "The existence of a cause for debarment does not necessarily require that the person be debarred; the seriousness of the person's acts or omissions and any mitigating factors shall be considered in making any debarment decisions." 24 C.F.R. § 24.300. The debarment regulations explicitly provide that "[d]ebarment and suspension

are serious actions which shall be used only in the public interest and for the Federal Government's protection *and not for purposes of punishment.* 24 C.F.R. § 24.115(b) (emphasis added).

In this case, the intent of the ALJ was clearly to send a message and to provide a deterrent. Although some deterrent effect is a permissible and expected side effect of a debarment, where that effect is the sole desired impact, it calls into question the propriety of such an action. This conclusion is supported by the recent decision of the Supreme Court in *United States v. Halper,* 109 S.Ct. 1892 (1989). Although *Halper* may not be directly on point, it certainly provides useful precedent to this Court in its attempt to ascertain the propriety of the ALJ's actions. In *Halper,* the Court held that

> the determination whether a given civil sanction constitutes punishment in the relevant sense requires a particularized assessment of the penalty imposed and the purposes that the penalty may fairly be said to serve. Simply put, a civil as well as a criminal sanction constitutes punishment when that sanction as applied in the individual case serves the goals of punishment. 109 S.Ct. at 1898.

Admittedly, the fact "[t]hat a measure, such as debarment, may incidentally punish while it deters . . . does not transform it into a purely punitive sanction." *Janik Paving & Const., Inc. v. Brock,* 828 F.2d 84, 91 (2d Cir. 1987). However,

> a civil sanction that cannot fairly be said solely to serve a remedial purpose, but rather can be explained only as serving either retributive or deterrent purposes, is punishment. . . .

Halper at 1902.

This Court recognizes the premise espoused in *Janik*—that punishment is an unavoidable side effect of debarment. In this case however, this Court is called upon to

determine where the line is to be drawn between a debarment which serves the acceptable purposes of the debarment scheme, and that which is imposed primarily for the purposes of punishment. In its opinion, imposition of debarment in this case encroached too heavily on the punitive side of the line, and for those reasons was an abuse of discretion and not in accordance with the law.

This conclusion is supported by that reached in a similar decision, *Sellers v. Kemp,* 749 F. Supp. 1001 (W.D. Mo. 1990). The *Sellers* decision also involved a HUD debarment. In *Sellers,* the court criticized the Secretary, whose decision to impose debarment for a lengthy period of time was based on her decision to "send a message." The court held that the Secretary's language indicated that she wanted to make an "example" out of the debarred plaintiffs rather than "fitting an appropriate period of debarment to the actual conduct at issue." *Sellers* at 1009. While the facts of this case are not as egregious as those in *Sellers,* the holding of *Sellers* is nonetheless applicable. The bottom line purpose of the debarment in this case was to send a message of deterrence and to make an example out of the plaintiffs. This Court cannot divine the ALJ's rationale for seeking to impose such a sanction; however, after thoroughly reading and analyzing the Order, this Court inescapably concludes that its overall effect, indeed its primary accomplishment, whether intentional or incidental, is punishment. This is clearly impermissible, and warrants reversal of the ALJ's Order.

Because the Court reverses the ALJ's Order on this basis, it need not address the remaining issues presented by the plaintiffs.

IT IS SO ORDERED.

/s/ David C. Norton
DAVID C. NORTON
United States District Judge

April 8, 1991

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF SOUTH CAROLINA
CHARLESTON DIVISION

C.A. #2:90-1184-18

R. GORDON DARBY,
DARBY DEVELOPMENT COMPANY,
DARBY REALTY COMPANY,
DARBY MANAGEMENT COMPANY, INC.
MD INVESTMENT,
PARKBROOK ACRES ASSOCIATES, and
PARKBROOK DEVELOPERS,

Plaintiffs,

vs.

HONORABLE JACK KEMP
Secretary of U. S. Department
of Housing and Urban Development
451 7th Street, S.W.
Room No. 10000
Washington, D.C. 20410,

C. AUSTIN FITTS, Assistant
Secretary for Housing/FHA
Commissioner
451 7th Street, S.W.
Room No. 9100
Washington, D.C. 20410,

and

THE UNITED STATES OF AMERICA,

Defendants.

ORDER

[Filed Oct. 26, 1990—Entered Oct. 29, 1990]

This matter is before the Court on the defendants' motion to dismiss and the plaintiffs' motion and amended motion for a preliminary injunction.[1] For reasons discussed more fully below, both the motion to dismiss and the motion for a preliminary injunction are denied.

FACTUAL BACKGROUND

Plaintiff Robert Gordon Darby ("Mr. Darby") is a well-respected self-employed real estate developer who conducts business in South Carolina. In 1977, he formed the Darby Development Company, and began developing and managing multi-family rental projects through the company. To obtain financing for his multi-family projects, Mr. Darby consulted Lonnie Garvin, Jr. ("Mr. Garvin"), a mortgage banker from South Carolina.

Mr. Garvin's company, the Mid-South Financing Company, was established in 1976. Shortly after its establishment, Mid-South became a Housing and Urban Development ("HUD") approved mortgagee concentrating in HUD multi-family rental insurance programs. In early 1981, Mr. Garvin originated a financing plan (the "Mid-South Financing Plan") to enable multi-family developments to use the single family mortgage insurance program to finance the construction of rental units on existing lots. Although the following description is somewhat

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[1] After oral argument, plaintiffs filed a motion to amend the previous motion for a preliminary injunction. This motion was based on a September 21, 1990 letter from HUD to plaintiffs setting forth additional consequences of the sanctions against plaintiffs. Subsequently the action taken in the September 21, 1990 letter was reversed in letters of October 1, 1990 and October 2, 1990. Therefore, it appears to this Court that the motion to amend should be denied as the issue has now become moot.

Along with their motion to amend, the plaintiffs also filed a motion for summary judgment. That motion is not being considered at this time.

simplified[2], the Mid-South Financing Plan worked as follows: The person seeking financing used straw purchasers as mortgage insurance applicants. The straw purchasers were actually Mid-South employees. Once loans were closed, the straw purchasers would then transfer title back to the development company or to a syndicated limited partnership. The purpose for the use of the straw purchasers was to ensure technical compliance with the "Rule of Seven", 24 C. F. R. § 203.42. The "Rule of Seven" is a HUD regulation that makes rental properties ineligible for single family insurance if the mortgagor already has financial interests in seven or more similar rental properties in the same project or subdivision.[3] The "Rule of Seven" is designed to prevent mass default on single family loans.

In mid-1981, after devising the Mid-South Financing Plan, Mr. Garvin contacted the HUD Columbia office to determine whether the application of the "Rule of Seven" would be satisfied by dividing up the units so that any particular borrower would have no more than seven units at the time of the loan closing. At that time, Mr. Garvin learned from HUD employees Henry Granat, Deputy Director for Housing Development, and Robert DesChamps, Chief of the Mortgage Credit Bureau, that the Mid-South Financing Plan would not violate the "Rule of 7". Thereafter, Mid-South prepared applications for firm commitments and Mr. Garvin again met with Mr. DesChamps and Mr. Granat. This meeting occurred in November of 1981. At the meeting, Mr.

[2] A more detailed description of the intricate workings of the financing plan can be found in the April 13, 1990 Order of the Administrative Law Judge.

[3] *See* 24 C.F.R. § 203.42 (a), which provides that appliacnts are not entitled to mortgage insurance if, at the time of the application, the property involved was "part of, or adqjacent or contiguous to a project, subdivision or group of similar rental properties which involve eight or more dwelling units if the mortgagor or principals have any financial interest in such properties."

Garvin more fully outlined the elements of the Mid-South Financing Plan. Mr. DesChamps, at the direction of Mr. Granat and in the presence of Mr. Garvin, called HUD Headquarters in Washington, D. C. and spoke with Ruth Studer, a HUD employee in the Headquarters Single Family Division, Mortgage Credit Section. Ms. Studer was the "point person" for dealing with questions in this area. Based upon the description she was given over the telephone, she advised that the HUD requirements would not be violated.[4]

Although various HUD employees in Columbia knew of the financing method, they only slowly became aware of the extent to which it was being used by Mid-South. This was largely due to the lack of a tracking system which could match the volume of applications for units with the locations of these units. At some point in 1983, an onsite visit by HUD representatives resulted in a realization of the extent and location of the rental projects being financed by Mid-South under the single family mortgage insurance program.

Consequently, Mr. Granat asked his employees to review the propriety of their approval of these applications and was assured that everything was in order. How[illegible] to double-check, Mr. DesChamps again contacted [illegible] Studer on March 30, 1983.[5] At this time Mr. DesChamps explained to Ms. Studer, in greater detail, the actual mechanism of the Mid-South Financing Plan. Ms. Studer again raised no objections to the process.

[4] Ms. Studer is now retired, and does not remember this conversation. However, she testified that she received approximately 30 questions relating to the "Rule of Seven" per week and that she would have said it would be consistent with HUD rules for an individual who had obtained FHA loans on seven units to sell or transfer the properties and come back for seven more as long as there was no continuing financial interest held by the seller.

[5] Ms. Studer has no independent recollection of this conversation either.

In the spring of 1983, HUD Columbia office employees brought to the attention of the office head, Franklin H. Corley, Jr., the volume of units being generated by Mid-South. At about the same time, another builder asked permission to use the Mid-South financing method for its properties. Mr. Corley orally advised the builder that he could use the Mid-South program because HUD Columbia had permission from Washington to use this type of plan. Shortly thereafter, the builder informed Mr. Corley that his attorney had advised him not to participate in such a financing arrangement because it was a violation of the multi-family rules and regulations.

Mr. Corley then asked his staff to prepare a memorandum summarizing the Mid-South Financing Plan. This memorandum was sent to Phillip Abrams, Acting Assistant Secretary for Housing/FHA Commissioner. The memorandum described the financing agreement as a proposal and did not make clear or in any way allude to the fact that this proposed agreement had in fact been used on over a thousand occasions.

Mr. Abrams' reply, dated September 23, 1983, stated that the proposal would be unacceptable. The reply further noted that the plan was a vehicle to circumvent the regulations limiting the number of closely located rental units in which the same mortgagor may have a financial interest (the "Rule of Seven").

Thereafter, Mr. Darby's loans went into default, despite what the ALJ termed as "Herculean efforts" on the part of Mr. Darby to resolve the problems and save the projects from financial downfall. In fact, due to circumstances beyond the control of Mr. Darby and Mr. Garvin, virtually all of the mortgage loans obtained through the Mid-South Financing Plan, including Mr. Darby's loans, went into default and HUD ultimately was required to pay substantial insurance on the defaulted loans. Naturally, this led to an investigation of the Mid-South Financing Plan.

A HUD audit of the loan transactions was initiated and conducted in the fall of 1986 to discover if there had been any wrongdoing. That audit report concluded that there was no wrongdoing on the part of either Mr. Garvin or Mr. Darby and that neither the HUD Columbia Office nor HUD Headquarters had been misled in any way. Additionally, the United States Attorney declined to pursue a criminal prosecution because the evidence did not support an intent on the part of Mr. Darby or Mr. Garvin to commit a crime.

Inexplicably, on June 19, 1989, HUD, through the manager of its Columbia, South Carolina office, issued plaintiffs a notice of limited denial of participation ("LDP") for a period of one year.[6] On July 21, 1989, plaintiffs filed an appeal from the issuance of the LDP.

On Augsut 23, 1989, HUD's Assistant Secretary notified the plaintiffs of a proposed debarment. On August 28, 1989, the Assistant Secretary for Housing filed a formal complaint requesting debarment. The plaintiffs appealed from the proposed debarment.

The appeal from the LDP was consolidated with the appeal from the proposed debarment and an extensive hearing was held in Charleston, South Carolina, from December 19 to December 22, 1989. On April 13, 1990, the ALJ issued his order in which he found that good cause existed to debar Mr. Darby and his affiliates for a period of 18 months, beginning on June 19, 1989, the date the LDP was imposed. The debarment is effective throughout all agencies in the executive branch and prevents plaintiffs from providing services as a contractor to those agencies and from participating in any federal nonprocurement programs. The ALJ also found adequate evidence to uphold the issuance of the LDP. The LDP expired on June 19, 1990. The debarment will expire on December 20, 1990.

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[6] The basis for the issuance of the LDP and subsequent debarment are discussed more fully below. *See* "Factual Background."

On May 31, 1990 plaintiffs filed a complaint for declaratory and injunctive relief from the Order of the ALJ. Also on May 31, 1990, plaintiffs filed a motion for a preliminary injunction. The motion for a preliminary injunction seeks an order restraining defendants from taking further action to implement the debarment until final adjudication of the complaint for declaratory and injunctive relief. This motion was opposed by the defendants.

On July 7, 1990, defendants filed a motion to dismiss the plaintiffs' complaint for declaratory and injunctive relief. The basis of this motion to dismiss is that the plaintiffs failed to exhaust their administrative remedies with HUD prior to proceeding on the complaint for declaratory and injunctive relief.

After hearing oral argument and reviewing the briefs, record of the ALJ, and other exhibits, this Court finds, for reasons discussed more fully below, that: (1) the defendants' motion to dismiss should be denied; and (2) the plaintiffs' motion for a preliminary injunction should also be denied.

DISCUSSION

A. *DEFENDANTS' MOTION TO DISMISS*

Defendants filed a motion to dismiss based on plaintiffs' failure to exhaust their administrative remedies with HUD as prescribed by 24 C.F.R. § 24.314. Section 24.314(c) provides that:

> [t]he hearing officer's determination shall be final unless, pursuant to 24 C.F.R. Part 26, the Secretary or the Secretary's Designee, within 30 days of receipt of a request decides as a matter of discretion to review the finding of the hearing officer. The 30 day period for deciding whether to review a determination may be extended upon written notice of such extension by the Secretary or his designee. Any party may request such a review in writing within 15 days of receipt of the hearing officer's determination.

If the Secretary determines within his discretion to review the determination of the ALJ, then section 24.314(e) further provides that:

> [s]uch a review or determination shall be issued within 30 days of the decision to grant review, unless written notice is given by the Secretary or designee extending the period for making such a determination.

Defendants contend that because plaintiffs failed to petition the Secretary for review within fifteen days of the ALJ's decision, as provided for in section 24.314(c), plaintiffs are now precluded from petitioning this Court for judicial review.

"The basic purpose of the exhaustion doctrine is to allow an Administrative Agency to perform functions within its special competence—to make a factual record, to apply its expertise, and to correct its own errors so as to moot judicial controversies." *Parisi v. Davidson*, 405 U.S. 34, 37 (1972). In determining whether the exhaustion doctrine should be applied in a particular case, this Court must balance the competing interests at stake—the policy served by the doctrine on the one hand versus its impact on the particular litigants on the other hand. *United States Ex Rel Brooks v. Clifford*, 412 F.2d 1137 (1969). The exhaustion requirement is not to be applied 'blindly in every case'". *McGee v. United States*, 402 U.S. 479, 484-85 (1971), citing *McKart v. United States*, 395 U.S. 185, 201 (1969).

Section 24.314 of the CFR does not explicitly provide a provision establishing that a person who fails to exhaust administrative remedies available thereunder is precluded from obtaining judicial review. Further, 5 U.S.C.A. §§ 701-706, which pertains to "Judicial Review" of an

agency decision, contains no such express mandatory provision.

Of course, even absent an express statutory provision, this Court is nonetheless guided by the general rule at common law that administrative remedies must be exhausted prior to proceeding in court. As noted above, however, this rule is not to be applied blindly in every case. This Court notes several concerns which militate against a blind application of the rule under the facts of this case. One concern is that a dismissal would leave the decision of the ALJ wholly unreviewed.

Another more significant concern is that, under the facts of this case, the available remedy is inadequate. A final concern is that exhaustion of the final administrative remedy would have been futile under the facts of this case.

In assessing the adequacy of the administrative scheme the Court notes the following: Under the administrative scheme available in this case the Secretary is entitled to decide whether to review an administrative decision. In making this discretionary call, the Secretary is initially allowed thirty days. However, should the Secretary not make the decision within the allotted time, he has the latitude to further extend the period within which he will issue his determination as to whether or not he will review the decision of the ALJ. Further, after this protracted period, the Secretary is entitled to an additional thirty day to render a decision as to whether to uphold or vacate the decision of the ALJ. Again, however, the Secretary can, of his own accord, extend that time.

The defendants cite for the Court's review the case of *Thetford Properties v. Dept. of Hous. & Urban Dev.*, 907 F.2d 445 (4th Cir. 1990). *Thetford* is distinguishable from the facts of this case. In *Thetford*, the plaintiff never filed a "plan of action" with HUD as required by the regulations, but instead sought immediate relief in

the federal court. There was no hearing and no record made at the administrative stage. The court, in holding that the plaintiff had failed to exhaust his administrative remedies, noted the importance of compliance with such remedies in that case because compliance could well have resulted in an elimination of the need for the palintiff to resort to the federal forum.

In *Thetford*, the court contrasted that factual situation with the one presented in *Coit Independence Joint Venture v. Federal Savings and Loan Ins. Corp.*, —— U.S. ——, 109 S.Ct. 1361, —— L.Ed.2d —— (1989). In *Coit*, the Court held the FSLIC's process for adjudicating claims to be inadequate because it imposed no well-defined time limits for agency action. In *Thetford*, however, the pertinent HUD regulations "demand[ed] prompt processing." 907 F.2d at 449.

The facts of this case lie somewhere between the facts in *Thetford* and those in *Coit*. Although the administrative process available in this case is not as flawed as that in *Coit*, it is also not as prompt and effective as that found to be adequate in *Thetford*. The inadequacy here lies in the latitude given the Secretary in determining the time limits within which to issue a decision.

Based on the concerns present in this case regarding the adequacy of the administrative remedy, as well as the probability that resort to that remedy would have been futile, this Court finds that the defendants' motion to dismiss should be denied.

B. *PLAINTIFF'S MOTION FOR A PRELIMINARY INJUNCTION*

The standard for securing a preliminary injunction is well established. There are four factors which enter into a determination of whether to grant or withhold interim relief: (a) the plaintiff's likelihood of success on the merits in the underlying dispute between the parties; (b) whether the plaintiff will suffer irreparable injury

if interim relief is denied; (c) the injury to the defendant if an injunction is issued; and (d) the public interest. *North Carolina State Ports Authority v. Dart Container Line Company*, 592 F.2d 749, 750 (4th Cir. 1979). Further, there is a correlation between the likelihood of the plaintiff's success on the merits and the probability of irreparable injury to him. If the likelihood of success is great, the need for showing the probability of irreparable harm is less. *Id.*

In assessing the likelihood of success on the merits, this Court must keep in mind the standard of review ultimately applicable in the underlying action. The role of this Court, when called upon to review an administrative decision to debar a contractor, is to determine whether that decision was arbitrary, capricious, or an abuse of discretion not in accordance with the law. *Camp v. Pitts*, 411 U.S. 138 (1973); *Citizens to Protect Overton Park v. Volpe*, 401 U.S. 402 (1971). In applying the arbitrary and capricious standard, the scope of judicial review is limited to whether the agency action was "rational, based on relevant factors and within the agency's statutory authority." *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Ins. Co.*, 463 U.S. 29 (1983). The ultimate standard of review is an extremely narrow one. This Court is not allowed to substitute its judgment for that of the ALJ. *Citizens* at 416.

The standard for a preliminary injunction when coupled with the above-mentioned standard of review of an ALJ decision results in an extremely heavy burden for the plaintiffs in this case. Unfortunately, it also limits this Court's ability to render immediate justice in a situation, such as this, in which it finds the defendants' conduct particularly egregious. The result of this limitation is that despite the fact that Mr. Darby actually had little to do with the creation of the financing arrangement in this case, despite the fact that it was explicitly approved by HUD in Columbia and in Washington on

two separate occasions, and despite the troubling fact of HUD's inability to comprehend and/or apply its own regulations, and its complicity in this matter, this Court's hands are tied.

As noted above, when the plaintiff's likelihood of success on the merits is slight, the burden of showing irreparable injury is heavier. In this case, the plaintiffs have demonstrated economic injury which they will suffer if interim relief is not granted. However, given the balancing which must be done when the likelihood of success on the merits is not favorable, this Court would have to find that the financial impact is of considerable significance in order to grant the remedy sought. This Court does not find the financial injury in this case to be of a sufficient magnitude to override the plaintiffs' burden as to the likelihood of success on the merits.

The remaining two factors merit only brief discussion. The third factor for consideration is the injury to the defndaent if an injunction is granted. Arguably, any injury to the government appears at first glance to be slight. However, the system of debarment is designed to insure that persons dealing in the area of government contracts do so carefully and fairly. If this Court were to grant an injunction under the facts of this case, the result would be to undermine the integrity of the debarment system. This also impacts adversely to the public interest, which is the fourth factor for consideration.

As noted above, all of the factors relevant to the granting of a preliminary injunction must be carefully balanced in making a determination as to whether to grant relief. After considering the pertinent factors in light of the circumstances presented in this case, this Court concludes that it must deny the motion for a preliminary injunction.

This ruling ,however, should not be construed as a ruling on the ultimate success or failure of the merits of

the underlying action. A ruling on a motion for a preliminary injunction is not a substitute for an adjudication on the merits. Those matters must be left to an appropriate time when that decision is properly before the Court.

CONCLUSION

For the reasons discussed above, the defendants' motion to dismiss is denied. Plaintiffs' motion for a preliminary injunction is also denied.

AND IT IS SO ORDERED.

/s/ David C. Norton
DAVID C. NORTON
United States District Judge

Charleston, South Carolina

October 25, 1990

APPENDIX D

UNITED STATES OF AMERICA
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
OFFICE OF ADMINISTRATIVE LAW JUDGES

HUDALJ 89-1373-DB (LDP)
HUDALJ 89-1387-DB

IN THE MATTER OF: ROBERT GORDON DARBY, AND DARBY DEVELOPMENT COMPANY, INC.; DARBY REALTY COMPANY; DARBY MANAGEMENT COMPANY, INC.; MD INVESTMENT; PARKBROOK ACRES ASSOCIATES; AND PARKBROOK DEVELOPERS; AFFILIATES,

Respondents.

Ronnie Ann Wainwright, Esq.
Bruce S. Albright, Esq.
Andrea Q. Bernardo, Esq.
For the Government

G. Richard Dunnells, Esq.
Steven D. Gordon, Esq.
Michael H. Ditton, Esq.
For the Respondents

Before: WILLIAM C. CREGAR
Administrative Law Judge

INITIAL DECISION AND ORDER

Introduction

Respondent, Robert Gordon Darby, appeals from the imposition of a Limited Denial of Participation ("LDP") issued by the Columbia, South Carolina Office of the U.S.

Department of Housing and Urban Development ("HUD" or "the Department") on June 19, 1989. He also appeals a debarment proposed by HUD's Assistant Secretary for Housing on August 23, 1989. HUD proposes that Mr. Darby and his affiliates, Darby Development Company, Inc., Darby Realty Co., Darby Management Co., Inc., MD Investment, Parkbrook Acres Associates, and Parkbrook Developers be debarred from further participation in primary covered transactions and lower-tier covered transactions (*see* 24 CFR 24.110(a)(1)) as either participants or principals throughout the Executive Branch of the Federal Government, and from participating in procurement contracts with HUD for an indefinite period commencing on June 19, 1989.[1]

The LDP prohibits Respondent's participation in all programs administered by the Assistant Secretary for Housing in South Carolina for one year. The appeal of the LDP was consolidated with the appeal of the proposed debarment on September 13, 1989. A hearing on the consolidated appeals was held in Charleston, South Carolina, from December 19th to 22nd, 1989. Post-hearing briefs were filed on February 5, 1990.

The LDP and proposed debarment allege that Mr. Darby used a scheme which employed "strawbuyers" to obtain FHA single family mortgage insurance which he could not have otherwise obtained. The method used by Mr. Darby is alleged to have certain consequences which violate various HUD rules. First, it is claimed that the applications submitted to HUD by the "strawbuyers" contain false information. The Department contends that even if HUD employees knew the actual facts regarding the transactions, as opposed to those stated on the application, these employees could not waive the requirement that

[1] The August 23, 1989 letter proposed debarment for five years. By letter dated November 16, 1989, this letter was amended. Additional allegations were added and the length of the proposed debarment was increased to an indefinite period.

the applications be filled out truthfully. Second, the method used by Mr. Darby permitted him to obtain FHA mortgage commitments without making the minimum investments required by HUD rules. Third, this method circumvented safeguards established in the multifamily insurance program which should have applied to these properties. Finally, the consequence of Mr. Darby's actions was to saddle HUD with single family commitments, the loans for which he purposefully defaulted, thereby placing these properties in the HUD inventory. The Department contends that it cannot be estopped from debarring Mr. Darby and that his abuse of HUD programs was willful and so extensive as to warrant Mr. Darby's indefinite debarment.

Mr. Darby contends that the method used did not violate HUD regulations, and that there was a complete disclosure of the means used to obtain the insurance made to employees of the HUD Columbia Office which approved the mortgage insurance commitments. In addition, an employee at HUD Headquarters was advised of the method used and approved of it. He argues, therefore, that the Department is estopped from debarring him. He also provided evidence of his good character and reputation as well as the extensive efforts he made to reduce the damage to HUD once the defaults had occurred. As a result, he contends that neither the LDP nor the debarment is warranted, and, in any event, the proposed debarment for an indefinite period is far too severe for what occurred, and is, therefore, punitive[2]. He also notes that a considerable period has passed between the alleged misconduct and the LDP and debarment actions. In fact, changes have been made to HUD rules which would prevent Mr. Darby's present use of the method used at that time. Accordingly, he contends that no purpose is served by the LDP or a debarment for any period.

[2] HUD regulations prohibit the use of debarment for punitive purposes. 24 CFR 24.115(b).

Findings of Fact

General Background

Robert Gordon Darby is a self-employed real estate developer who conducts his business in South Carolina. He graduated from Newberry College, South Carolina, in 1961 and from the Northwestern University School of Mortgage Banking in 1963. He worked for Carolina National Mortgage Co. in Charleston until 1965. After working as a real estate agent, he formed the Darby Realty Company in 1968, selling residential real estate and insurance. In 1971, doing business as Darby Construction Co., he began building single family homes as well as several mobile home parks and single family subdivisions. He built approximately 1500 homes. In 1977, he stopped building single family homes, formed the Darby Development Company, and began developing and managing multifamily rental projects throught that company. He developed approximately eight projects comprising approximately 1,000 units. (Tr. pp. 799-803) He began dealing with HUD in 1961 and has continued to work with HUD since that time. (Tr. p. 804) He is familiar with HUD single family and multifamily programs. He has a reputation in the HUD Columbia Office for honesty and professionalism. (Tr. pp. 390, 391, 586, 607)

Lonnie Garvin, Jr., is a mortgage banker. Also from South Carolina, he graduated from the University of South Carolina in 1958. He began his career with Southern Mortgage Company, an FHA approved mortgagee, in 1958. He worked his way from loan servicing agent through loan origination officer to president of the company in 1972. In 1976, he and other Southern Mortgage employees left to form a new company, Mid-South, which also became a HUD-approved mortgagee concentrating in HUD multifamily rental insurance programs. (Tr. pp. 651, 652) He was the president of Mid-South until

December 1985 when its parent company made the decision to relocate its principal activities to Greenville, South Carolina, at which time he left the company. (Tr. pp. 652, 653) Mr. Garvin has extensive experience with HUD programs, principally in the Section 221(d)(4) multifamily rental insurance program. He has a reputation in the HUD Columbia Office of being an extremely knowledgeable and trustworthy mortgagee. (Tr. pp. 408, 410, 587, 588)

In 1981, the real estate market in South Carolina was depressed. There was little single family or multifamily development activity due to high interest rates. (Tr. pp. 71, 73, 224, 225, 395, 451, 581, 657, 658, 808, 812) There was also a severe shortage of rental housing. (Tr. p. 657) In early 1981, Mr. Garvin originated a plan to use the existing HUD/FHA single family mortgage insurance program (12 U.S.C. Sec. 1709(b)) to finance the construction of rental units on existing lots. Once he obtained financing for the construction of the units, he would pay off the construction loans with the proceeds from the single family mortgage insured by HUD. Once the units were constructed, they would be rented. Mr. Garvin recognized that there would be a period where there would be a negative cash flow. This was because the rents could not be set high enough to offset the debt service resulting from the high interest rates. His plan envisioned the use of syndication. A syndicate would own the property and cover the operating deficits in return for tax write-offs for its limited partner investors. He also anticipated that the high rate of inflation would continue and would drive up rents. Once interest rates came down and the rents increased, a point would be reached when the properties could be sold or refinanced. (Tr. pp. 658-660) He expected this point to be reached in four to five years. (Tr. pp. 660, 661) The units were to be designed for resale as single family homes. They would have individual water meters, sewer taps, and

would be architecturally designed to blend with surrounding single family housing. (Tr. p. 659)

One of the principal HUD programs provides for the insurance of single family mortgages. This is authorized by Section 203(b) of the National Housing Act.[3] The purpose of the single family mortgage insurance program is to facilitate home ownership by owner-occupants. (Tr. pp. 33, 261, 330) However, until recently, limited use of the program by investors was permitted. (Tr. pp. 36, 190, 330).[4]

Although the HUD/FHA single family mortgage insurance program could be used for investment purposes in the early 1980s, this was not its primary purpose. The statute, as implemented by HUD, set forth certain restrictions on the use of this program for speculation. The two limitations pertinent to this case are: (1) the restrictions on the amount HUD can insure, i.e., minimum investment requirements and (2) limitations on the number of mortgages issued to a single borrower.

Section 203(b) establishes limits on the amount of a mortgage which HUD can insure. HUD can insure no

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[3] 12 U.S.C. Sec. 1709(b).

[4] Two programs specifically authorized the use of this program by builders. These were the "builder escrow" commitment and the "builder bailout program". The first program permitted a builder to obtain a mortgage in his own name if the property were to be rented. His mortgage was limited to 85% of that available to an owner-occupant. This money was placed in escrow. In the event the property was not sold within 18 months, the amount placed in escrow would be applied to the mortgage and used to reduce HUD's commitment to what it would be for an investor. (Tr. p. 55, HUD HB 4000.2 Rev-1, para. 2-6(b)(4)). The second program permitted builders to refinance construction loans prompted by high interest rates. Again, builders were limited to a mortgage of 85% of that available to an owner-occupant. (Tr. p. 509) This program was temporary and existed from April 1980 to April 1981. (Tr. p. 37, 100). Neither of these programs was involved in this case. They do, however, demonstrate that under certain circumstances use of the program for investment purposes was permitted by Section 203(b).

more than 97% of the first $25,000 and 95% of any amount in excess of the first $25,000. Stated conversely, a minimum investment of 3% of the first $25,000 and 5% of any amount in excess of $25,000 is required to be paid by the borrower. (Tr. pp. 47, 77) As stated *supra*, investors were required to invest even more in the property, HUD's commitment being limited to 85% of the amount an owner-investor could obtain. (Tr. p. 76, HUD HB 4000.2 Rev-1, Para. 2-6(b)(4)(a) (April 1982)), Govt. Ex. G-154) The above rules applied to purchases. "Refinances" did not require any minimum investment.[5]

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[5] The minimum amount of investment for purchase by an owner-occupant is the difference between the "cost of acquisition" and the maximum allowable mortgage amount. The "cost of acquisition" is the contract sales price plus closing costs. In a refinance transaction, there is no "cost of acquisition" and no requirement for a minimum investment (Tr. p. 77, HUD HB 4000.2 Rev-1, Para. 2-11, Govt. Ex. G-93, Govt. Ex. G-154)). An illustration of the differences between the two types of transactions (purchase versus refinance) is set forth in the Inspector General's audit as follows:

"To illustrate the calculation of the insured mortgage amount on the case we reviewed, we will use a property with acquisition costs of $68,000 ($66,600 sales price plus $2,000 estimated closing costs) and an appraised value of $80,000. Based on these amounts a calculation of the maximum mortgage follows:

	Acquisition Cost	Mortgage Amount
97% of	$25,000	$24,250
95% of	43,600	41,420
Total acquisition cost	68,600	$65,670
Maximum mortgage for owner-occupant		65,670
		85%
Maximum mortgage for owner-non-occupant		$55,800
Acquisition cost		$68,600
Maximum mortgage		55,800
Minimum investment		$12,800

Because the loans were represented as refinancing transactions instead of purchases, the mortgage insured by HUD was 85 percent

HUD also placed limitations on the number of properties for which HUD would commit mortgage insurance held by the same borrower. This "Rule of Seven", set forth in HUD regulations as early as December 1971, is stated in a HUD Handbook as follows:

> A mortgage on a property upon which there is a one to four family dwelling to be rented by the mortgagor is not eligible if the property is a part of, or adjacent or contiguous to a project, subdivision or group of similar rental properties which involve eight or more dwelling units in the mortgagor or principals have any financial interest in such properties. The terms "adjacent" and "contiguous" mean touching or adjoining.

(HUD HB 4155.1, Para. 1-14(g) (April 1977), Govt. Ex. G-153(a))[6]

Both of these restrictions are designed to limit defaults. The requirement for a minimum investment acts to reduce the amount of debt service. The restriction on the number of single family units held by the same borrower is designed to prevent mass defaults. (Tr. pp. 39, 277) If a large number of properties enter the HUD

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of the maximum amount available to an owner-occupant using appraised value plus *closing costs, without regard to acquisition cost and the minimum investment.* In the case illustrated, the HUD-insured mortgage was $66,600 instead of $55,800:

	Appraised Value	Mortgage Amount
97% of	$25,000	$24,250
95% of	57,000	54,150
Total (including closing costs)	82,000	$78,400
		85%
Insured mortgage amount		$66,600

(Govt. Ex. G-93, p. 5) (Emphasis in original)

[6] *See also* 24 CFR 203.42.

inventory in the same geographic area, the cost to the taxpayer will be markedly increased. First, the difficulty of selling an extensive supply of properties results in increased management fees. Second, the availability of an extensive supply of housing tends to reduce the sales price of the properties. (Tr. p. 39)

The "Rule of Seven" was intended to reduce the risk of mass defaults by limiting the number of single family mortgages held by the same borrower in a given location. In effect it draws an arbitrary line between single family and multifamily projects.[7] In the case of multifamily projects, HUD has attempted to deal with the risk of mass defaults in the underwriting process and by maintaining oversight of the projects once the mortgage commitments have been issued. The Department insures multifamily projects pursuant to Section 207 of the National Housing Act.[8] The approach used in underwriting involves a different method of valuation. A single family mortgage is evaluated by the relationship of the debt to the resale value of the property, whereas a multifamily project is evaluated by the relationship of the debt to the income it can produce.[9] (Tr. pp. 276, 353) If the amount

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[7] Another distinction exists by virtue of the number of units in a particular "site". Any site with over four "rental dwelling units" is considered multifamily. 24 CFR 207.24(a). The Department does not contend that this rule was violated by Respondents.

[8] 12 U.S.C. Sec. 1702. There are two types of multifamily programs, "new construction" and "existing". Under the "new construction" program, Section 221, HUD will guarantee 90% of the net income. Under the "existing" housing program, Section 223(f), mortgages can be insured for the whole amount of developments which have been completed more than three years previously. (Tr. pp. 357-358)

[9] The Department determines the amount for which the units in the proposed project can be rented. It then estimates the "replacement cost" of a project and the "supportable cost". The "supportable cost" is the cost which can be supported by the projected income after subtracting the operating expenses. (Tr. p. 353)

of income is insufficient to support the debt, more "up front" money is required from the borrower. (Tr. p. 356) In addition, HUD requires: (1) a market analysis to determine financial feasibility; (2) cost certifications audited by independent public accountants to limit the maximum insured amount; and (3) "previous participation clearance" to evaluate the past performance of the borrower. (Govt. Ex. G-93, pp. 8, 9) HUD's oversight is accomplished through regulatory agreements[10], management agreements[11], the reporting of income and expenses, and model lease approval. HUD maintains the right to audit income and expenses and to require monthly market absorption reports. (Tr. pp. 353, 354) In addition to these requirements, HUD requires compliance with federal wage and hour laws and environmental protection laws. (Tr. pp. 358, 609)

As stated above, HUD rules in existence in the early 1980s provided for the insurance of existing mortgages as well as those incurred initially by way of a purchase and sale. These rules recognized that refinances differed from purchase and sale transactions in certain respects. The amount to be financed was less than for a new mortgage by an owner-occupant.[12] There was no "cost

[10] These provide HUD with certain controls over mortgagors. These controls include: (1) the requirement for an annual financial report certified by an independent public accountant; (2) a prohibition against paying out of funds except from surplus cash, except for reasonable operating expenses and necessary repairs, without HUD approval; and (3) HUD concurrence in any transfer of physical assets. (Govt. Ex. G-93, p.8)

[11] The management agreement must conform to the regulatory agreement. By approving the management agreement, HUD approves the management agent and management fee which is limited to those prevailing in the local area. (Govt. Ex. G-93, p. 8)

[12] The HUD rule in effect in 1982 states:

> An existing mortgage, insured or uninsured, may be refinanced with a new mortgage insured under this section. The maximum mortgage amount and loan-to-value ratio is the same as if it

of acquisition" in a refinancing transaction since the property was already owned by the borrower. The amount to be financed was based upon HUD's appraisal of the actual value of the property.[13] There was a requirement for the verification of the existing mortgage. (Tr. p. 107) If the amount of the new loan exceeded the original mortgage, the borrower could "pull out" the excess cash. There were no limitations placed on the use to which this money could be put. (Tr. pp. 190, 191, 221)[14] A HUD Handbook prohibited the use of permanent loans to refinance construction loans. However, this Handbook was not distributed to mortgagees.[15]

The restrictions placed on the issuance of multifamily commitments make it easy to see why a developer or lender, faced with high interest rates and a sluggish environment for multifamily projects would prefer the single family mortgage insurance program. The chief obstacle was the "Rule of Seven".[16]

> were a new mortgage, further limited to the larger of 85 percent of the amount of a new mortgage available to an owner-occupant, or the existing indebtedness related to the property plus the cost of repairs and refinancing. A statement of the purpose of the loan must accompany the application.

(HUD HB 4000.2 Rev-1, Para. 2-11 (April 1982), Govt. Ex. G-154)

[13] Appraisers could be either HUD employees, or contract or "fee" appraisers. HUD also accepted appraisals made by the Veterans Administration. (Tr. p. 77)

[14] Cash could not be taken out after May 16, 1985. (Tr. p. 98, Govt. Ex. G-138)

[15] Handbook 4190.1 was referred to but not introduced into evidence by the Department. (Tr. pp. 208, 217, 221) Because it is not distributed to mortgagees and because there is no evidence that either Respondent or Mr. Garvin were aware of its provisions, I have not considered it as a basis for sanctioning Respondent.

[16] Since the mid 1970s, waivers of the Rule of Seven have been granted by the Department. (Tr. pp. 89, 314) A regulation providing for such waivers became effective on October 6, 1982. *See* 24 CFR 203.248. That regulation provides that a waiver can be granted

The Garvin Transactions

In mid 1981, Mr. Garvin approached the HUD Columbia Office and learned from HUD employees, Henry Granat, Deputy Director for Housing Development, and Robert DesChamps, Chief of the Mortgage Credit Branch, that the application of the Rule of Seven would be satisfied by dividing up the units so that any particular borrower would have no more than seven units at the time of loan closing. (Tr. p. 663)[17] This entailed the use of an individual who would be given title to the

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only in writing by the Secretary or Assistant Secretary for Housing. Recommendations for a waiver of the rule are made by the local field office and approved by the Assistant Secretary for Housing. (Tr. pp. 40, 88) Waivers were approved in 1982-1983. (Tr. p. 314) Bill Park, Chief of the Single Family Mortgage Credit Branch in Headquarters, testified that, from the mid 1970s to 1985, waivers were seldom requested and were not normally granted. (Tr. pp. 89-90) He testified that, from 1985 to 1987, it was fairly typical to grant waivers in cases involving refinance transactions where investors with pre-existing HUD-insured loans sought to obtain lower interest rates. (Tr. p. 90). Mr. Nistler testified that, with regard to the period from February 1984 to March 1989, his tenure as Deputy Assistant Secretary for Single Family Housing, he does not recall an instance where a request for a waiver was denied. (Tr. 513)

[17] Mr. Garvin testified as follows:

> I asked what did they mean by that and I was told that a geographic area was a particular subdivision. And I specifically asked the question, "Then you're saying if I'm in subdivision A, we can do seven units but if I move across the street to subdivision B, we can do seven more, that's a different geographic area." I was told yes. And then I inquired as to when the Rule of Seven applied and I was told that it applied at the time of loan closing. At the time the loans were closed, one individual could not have more than seven units. In fact, we even had a discussion as to how you do duplexes if you were limited to seven units, could you do seven duplexes or could you do three and a half duplexes. . . The answer was it was units, we had to do three and a half and we could take two people together and use their halves to get 14 units out of two people.

(Tr. pp. 662-663)

property prior to closing and would subsequently transfer it to a syndicate. The individuals selected for this purpose were the employees of Mid-South.

The prototype for this method was a 30-unit duplex consisting of 15 duplexes called Plantation Ridge. Mid-South's development company, Tandem Development, and Southern Homebuilders, a construction company, formed a development partnership. This partnership located single family duplex lots and obtained options to purchase these lots based on obtaining HUD firm commitments for Section 203(b) mortgage insurance. Plans and specifications were submitted to the HUD Columbia Office together with applications for conditional commitments.

The issuance of mortgage commitments is a three-step process. The first step involves the issuance of conditional commitments. A lender submits an application and an appraisal is requested. After the site is evaluated and the property appraised,[18] construction can begin. Inspections are made during the construction phase and a final inspection report is issued. (Tr. pp. 397-402) The Valuation Branch is responsible during this phase.[19] The second step, or firm commitment process, involves the evaluation of the borrower's credit. This is done by the Mortgage Credit Branch, based upon application (HUD Form 92900) submitted by the borrower. After credit approval, a "firm commitment" is issued. The third step, insurance of the mortgage, takes place only after credit approval and final inspection.

The HUD Columbia Office, in accordance with single family commitment procedures, reviewed the plans and

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[18] Since there was no established purchase price, HUD appraisers determined the value of the property.

[19] The Rule of Seven does not apply to conditional commitments as the identity of the mortgagor is not known. There is no reference to the rule in the HUD Single Family Valuation Handbooks. (R. Ex. G, Tr. p. 469)

specifications, appraised the value of the finished units, and issued conditional commitments. Subsequently, a syndication, known as the March Company, agreed to syndicate the Plantation Ridge Development.

Mid-South prepared applications for firm commitments for mortgage insurance using a HUD Standard Form 92900.1, "HUD/FHA Application for Commitment for Insurance under the National Housing Act". (Tr. pp. 668, 669). These applications were signed by employees of Mid-South.[20]

Blocks 8(a) and 24(m) set forth the amount of the loan. This amount was determined by calculating the maximum insured mortgage amount based on the HUD appraisal. (Tr. p. 673)

Block 9(a) of the form states the purpose of the loan. This information assists HUD in determining the maximum loan amount. (Tr. p. 78) There are eight possibilities one of which is to be selected by checking the appropriate block. The blocks include the "purchase of an existing house previously occupied", purchasing an "existing home not previously occupied", "constructing a home-proceeds to be paid out of construction", or "refinance". In each case, the "refinance" block was checked.

Block 9(b) contains information regarding the type of borrower. The choices include "occupant", "builder", or "landlord". In each case the "landlord" block was checked.

Block 15 lists the estimated monthly payment, including debt service, taxes, etc. The amount shown on the application exceeds the estimated rental income listed in Block 23(a). Thus anyone reading the form would note that there is a shortfall.

[20] The applications, generically described below, are those submitted by Mr. Garvin and his employees in connection with Plantation Ridge and other projects. The Department introduced 89 exhibits containing various applications which involved the Respondent. (Govt. Exs. G-38 (d) to G-89 (d))

Blocks 21 and 22 list the applicant's assets and liabilities. Those listed were the personal assets and liabilities of the applying Mid-South employee, not those of the ultimate owner.

Block 24 contains spaces for the listing of the individual cost items comprising the total estimated cost of the property. This was calculated by estimating prepaid items, discounts, and closing costs, etc., and subtracting this amount from the HUD maximum insured amount listed in blocks 8(a) and 24(m). Block 24 is part of Section II of the form. Block 24(f) is checked if the borrower is applying to refinance a loan. (Tr. pp. 674-676) The forms were filled out with the notation, "payoff const. [construction] loan".

Block 31 is located in Section V of the form which is entitled "Borrowers Certification". Block 31(a)(1) asks, "Do you own or have you sold, within the past 12 months, other real estate?" This question is followed by six blocks which break the question into three separate components with "yes" or "no" answers. The question relating to ownership is answered, "yes." The next question "is it to be sold?" is answered, "no". The final question asks if it is a HUD/FHA mortgage. This question is answered, "yes".

Block 31(a)(3) asks, "If the dwelling to be covered by this mortgage is to be rented, is it a part of, adjacent or contiguous to any project, subdivision, or group rental properties involving eight or more dwelling units in which you have any financial interest?" In each case the block checked is "no". If the question were answered in the affirmative, a further question asks for details.

Block 31(b)(5) contains the following language: "The borrower certifies that all information in this application is given for the purpose of obtaining a loan to be insured under the National Housing Act, or guaranteed by the Veterans Administration and the information in Section

II is true and complete to the best of his/her knowledge and belief."

Block 33 states the following: "(S)ignature of borrower(s) (before signing, review accuracy of application and certifications.)"

Following the signature block and located at the bottom of the form is the following statement in bold print: "Federal statutes provide severe penalties for any fraud, intentional misrepresentation, or criminal connivance or conspiracy purposed to influence the issuance of any guarantee or issuance by the VA or USDA-FmHA Administrator or the HUD/FHA Commissioner."

The loan proceeds were to be used to refinance and pay off the construction loans that would be used to build the units with permanent financing at a relatively low rate. In the case of Plantation Ridge and other properties to follow, the construction loan was not obtained until after firm commitments were issued by HUD since the proposed construction lender required assurance that permanent financing would be available to pay off the construction loan. (Tr. pp. 670, 674) This is standard industry practice. (Tr. p. 670) Since construction lenders typically loan less than the value of the completed home, each of these transactions resulted in a surplus. (Tr. p. 675) This surplus could be pulled out of the transaction under existing HUD rules. (Tr. pp. 98, 678, Govt. Ex. G-138)

After the applications for firm commitments were prepared by Mid-South, Mr. Garvin again met with Mr. DesChamps and Mr. Granat. This meeting occurred in November 1981. At the meeting, Mr. Garvin made clear to these HUD employees the following elements of his plan: (a) that he (Mr. Garvin) was proposing the construction of projects consisting of more than seven units (Tr. pp. 452); (b) the Section 203(b) single family insurance program would be used for permanent financing of this construction (Tr. pp. 452, 453); (c) the applications would be made in the name of Mid-South employees in order to comply with the Rule of Seven (Tr. p. 453); (d) these employees would obtain title to properties, seven at a time, and transfer the properties to a syndicate (Tr. pp. 431, 432, 453, 454); and (e) the syndicate would cover the "shortfall" in return for tax write-offs (Tr. pp. 454, 455). What they were not told was that individuals owning interests in the entities transferring the properties to the Mid-South employees would get the properties back through other entities in which they also owned interests. (Tr. pp. 468, 469) Although these HUD employees did not realize initially that these transactions would be characterized by the borrowers as "refinances", they should have known this as soon as the applications were received. (Tr. pp. 431, 432)

Mr. DesChamps, at the direction of Mr. Granat and in the presence of Mr. Garvin, called HUD Headquarters in Washington, D.C., for advice. He spoke with Ruth Studer, a HUD employee in the Headquarters Single Family Division, Mortgage Credit Section. Ms. Studer was at that time one of two staff employees responsible for answering questions from the field relating to the single family mortgage credit programs. (Tr. pp. 59, 67) She had considerable expertise in this area and was described as the "point person" for dealing with field questions by the former Deputy Assistant Secretary for Single Family Housing, James Nistler. (Tr. p. 514) Based upon the description of the transaction she was given, she advised that HUD program requirements would not be violated.[21]

[21] Ms. Studer, who is now retired, does not remember either this conversation or the subsequent conversation discussed below. She testified that she received approximately thirty questions relating to the Rule of Seven per week. (Tr. p. 331) She testified that she would have said it would be consistent with HUD rules for an individual who had obtained FHA loans on seven units to sell or transfer

Mr. DesChamps prepared a memorandum of his conversation with Ms. Studer which is dated November 24, 1981. Delphic in its ambiguity, this document states that the thirty duplex proposal was described to Ms. Studer and that she said "... it was legal provided the Mortgage Credit Section imposed its limited ownership rules on the proposed mortgagors." (Govt. Ex. G-109)[22]

The HUD Columbia Office approved the firm commitment applications for Plantation Ridge. A construction loan was secured by the Tandem/Southern Homebuilders' partnership. The homes were built and inspected by HUD during the construction. Upon completion, a final inspection was given. This is a prerequisite to the issuance of the mortgage insurance. (Tr. pp. 681, 709) Since Mr. Garvin intended this arrangement to constitute the refinancing of a construction loan, he understood that it was necessary for the "borrowers" to have title at the time of closing.[23] Thus, prior to closing these transactions, Tandem/Southern transferred the title to the units to the individual Mid-South employees. After closing, these same individuals transferred title to a syndicated limited partnership which owned and operated the units as Plantation Ridge Development. Tandem Development was the corporate general partner with a ½ of one per-

the properties and come back for seven more as long as there was no continuing financial interest held by the seller. (Tr. p. 334)

[22] The memorandum indicates that the primary concern of Messrs. DesChamps and Garvin was whether the Rule of Seven applied to seven units or seven duplexes. She told them it meant units.

[23] Where an individual borrows money to purchase property in the first instance, that purchaser does not have title at closing. (Tr. p. 433) Where an individual borrows money to refinance, he/she necessarily has title before closing. Because Mr. Garvin intended to characterize these transactions as refinances, he had to demonstrate that the borrowers had title no later than the closing. This is consistent with Mr. Garvin having been told by HUD Columbia Office employees that the relevant time for purposes of applying the Rule of Seven was the time of closing. (Tr. p. 663)

cent interest. The other general partner, also with a ½ of one percent interest, was Mr. Garvin. (Tr. p. 681) The limited partners held the remaining 99 percent.

The limited partnership was syndicated through the March Company. (Tr. p. 682) It took title to the units "subject to" the insured mortgages rather than "assuming" the mortgages. Assumption of the mortgages would have adversely affected the tax basis of the limited partnership and its partners (Tr. pp. 687, 688, 693, R. Ex. RR) The "borrowers" remained contingently liable on the mortgages. (Tr p. 776)

Subsequently, Mid-South used the Plantation Ridge financing and syndication process for other developments.[24] Between 1981 and 1984, Mid-South processed approximately 1050 Section 203(b) applications through the HUD Columbia Office. Over 1600 units were developed. (Tr. pp. 704, 705) At the HUD Columbia Office most of these applications were processed by one man, Charles Bennett, who worked under the supervision of Mr. DesChamps. (Tr. p. 602) There was no attempt to conceal these transactions. Application packages too bulky to mail were grouped together and sent by Mid-South in boxes by bus to the HUD Columbia Office. Mr. Bennett "kept score" to make sure that no Mid-South employee had title to more than seven properties at a time. (Tr. pp. 683, 686) Upon completion of the Plantation Ridge transactions, Mr. Garvin advised Mr. DesChamps by letter that the "individual owners" deeded the property to Plantation Ridge Associates which was now financially and legally responsible for the units.

[24] After other projects were developed, U.S. Shelter Corporation, the parent of Mid-South, became the management agent for most of the projects. The general partners executed operating deficit loan agreements with the limited partnerships agreeing to fund the oprating deficits for a specific period, usually four to five years. The permanent loans were placed in GNMA Mortgagee-Backed Securities Pools. (Govt. Ex. G-93, pp. 1-2)

(R. Ex. NNN). Other letters and reports on the status of the later projects were sent by Mr. Garvin to Mr. DesChamps. These clearly establish that Mr. DesChamps knew that the applicants for firm commitments were not, in fact, and were never intended to be, the ultimate purchasers.[25]

While HUD employees in Columbia knew of and approved the financing pattern, they only slowly became aware of the extent of its use by Mid-South. This was because HUD did not have a tracking system to match the volume of applications for units with the geographic locations of these units. (Tr. p. 383) At some point in early 1983, the Director of Housing and Mr. Granat made a site visit to one or more of Mid-South's projects. (Tr. p. 466) Their report resulted in the first conscious realization by HUD Columbia Office personnel of the extent and location of the rental projects Mid-South was financing under the single family mortgage insurance program. In the understated words of Mr. DesChamps, "we got a little burned." (Tr. p. 467)

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[25] On April 23, 1982, Mr. Garwin requested Mr. DesChamps to reconsider his rejection of the application of a Wayne Baker in another development, Tarpon Bay II, because of his insufficient funds. Mr. Garvin pointed out that Mr. Baker's funds were actually going to be covered by the tax syndication. He also requested that Baker's name be substituted on applications which had previously been approved in Mr. Garvin's own name because the March Company had determined that Mr. Garvin's role as applicant conflicted with his role as general partner. (R. Ex. QQ) On June 30, 1982, Mr. Garvin requested Mr. DesChamps to substitute another borrower, Mr. Tucker, because he was to become a general partner in the Tarpon Bay II partnership. (R. Ex. RR) On March 31, 1983, Mr. Garvin wrote to Mr. DesChamps informing him that Plantation Ridge and Tarpon Bay II were completed. He stated that "[o]ur people no longer have any financial responsibility for those units." The rest of the letter goes on to tell Mr. DesChamps about the progress of other developments, Oak Ridge, Greenhurst, Maritimes and Parkbrook Acres. (R. Ex. TT)

This knowledge stanched neither the flow, nor approval, of Mid-South applications, however. Mr. Granat asked his section chiefs to review the correctness of their approval of the applications and was told by them that everything was in order. (Tr. p. 599) Just to make sure, Mr. DesChamps again contacted Ms. Studer on March 30, 1983. A memorandum to Mr. Granat of this conversation was prepared on April 8, 1983.[26] This memorandum states a great deal more about the nature of the transactions than the previous memorandum of November 24, 1981. In the memorandum Mr. DesChamps states that he explained to Ms. Studer, "in detail," that "we were issuing firm commitments to applicants who were closing the loans and then transferring ownership to the March Company for syndiaction. The March Company in turn was selling ownership to Limited Partners as investors." Mr. DesChamps states that he asked Ms. Studer whether HUD should be concerned with the "one entity ownership" of these units. She replied that although the ideal way to transfer title would be through the use of an assumption, HUD had no control over what the owners did with the property since it was "invested in fee simple". A mortgagor could elect not to assign and transfer the mortgage, thus retaining a contingent liability. The possibility of violating the Davis-Bacon wage and hour requirements was also discussed. The memorandum claims Ms. Studer was unconcerned with this and that what Mid-South was doing was "quite prevalent in California." The answer "no" to the question on the application concerning the ownership of more than seven units was also discussed. According to the Memorandum, Ms. Studer staid this answer should not be questioned because "this was [the applicant's] statement over his signature and certification." (Govt. Ex. G-111)

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[26] Again, Ms. Studer has no independent recollection of the conversation. (Tr. p. 331)

During this period the HUD Columbia Office was headed by Franklin H. Corley, Jr. He first focused on the Mid-South financing pattern in the Spring of 1983. (Tr. p. 373) It was brought to his attention by office employees who were concerned with the volume of units being generated by Mid-South. In addition, another builder had asked permission to use Mid-South's methods to finance its own properties. Mr. Corley orally advised the builder that he could use the Mid-South financing program because HUD Columbia "had permission from Washington to go in this direction." The builder "came back about two weeks later stating that his attorney advised him not to participate in this because he felt like it was a violation of the multifamily rules and regulations." (Tr. pp. 379, 380) Mr. Corley asked his staff to prepare a memorandum summarizing the Mid-South financing methods. Mr. Garvin was asked to provide information regarding the number of units for which commitments were issued together with their location. Mr. Garvin did so. (Tr. pp. 381-383). The requested memorandum, dated August 30, 1983, was sent to Philip Abrams, Acting Assistant Secretary for Housing/FHA Commissioner. The memorandum describes the transaction as follows:

> Attached is a confidential outline of a *proposal* . . . as a vehicle for financing groups of duplex units *to be constructed* in South Carolina.
>
> We have information that indicates these principals *wish to construct* 1600 such units throughout South Carolina, using this same financing arrangement. The contractors *expect* to *sell* the individual duplexes to the officers and employees of the Tandem Company who *will close* the loan on that unit. After the closing of the permanent loan on each duplex, it *will be sold* to the partnership subject to the FHA insured loan under Section 203(b).

(Emphasis added) (Govt. Ex. G-112)

The memorandum goes on to state, "We are concerned with the monitoring of a program so wide in scope as well as the risk of exposure we would have under the single entity ownership of the rental properties during the term of the insured loan." (Id.) Mr. Corley's memorandum is misleading. It does not reflect that the financing arrangement was a *fait accompli*; rather it is referred to as a "proposal" and is written in the future tense.[27]

Mr. Abrams' reply, dated September 23, 1983, states that the "proposal" is "unacceptable". It notes that the plan is a vehicle to circumvent the regulations limiting the number of closely located rental units in which the same mortgagor may have a financial interest and that there are no "long term risks to the partnership." (Govt. Ex. G-114) Because the memorandum to Mr. Abrams did not advise HUD Headquarters that Mid-South's activities had already been approved by the HUD Columbia Office in numerous cases, the reply does not require any corrective action.

Upon receipt of the Abrams' reply, the HUD Columbia Office stopped the approval of new applications but continued to process and approve firm commitments for 53 conditional commitments already issued to Mid-South. (Tr. pp. 706, 776, Govt. Ex. 93, p. 9) Mr. Corley offered to accompany Mr. Garvin to appeal HUD's decision. Mr. Garvin declined because he felt that ". . . we had all the property we could manage properly and handle." (Tr. pp. 706, 776, 785)

The Darby Transactions

I. Bay Tree and Oakfield

Mr. Darby's utilization of Mid-South's financing methods began in mid-1982. He had previously purchased two properties, Bay Tree, located in Mt. Pleasant, South

[27] Mr. Corley does not remember signing this memorandum but is familiar with it. (Govt. Ex. G-112, Tr. p. 379)

Carolina, and Oakfield, located in North Charleston, South Carolina. The Bay Tree and Oakfield developments involved existing housing units. These financing arrangements differed from the projects developed by Mr. Garvin in that the mortgages were assumed by Darby Development, Inc., and were not syndicated. Mr. Darby paid off the construction loans, but he and his company remained liable on the new mortgages. Mr. Darby used the syndication method advised by Mr. Garvin in developing Parkbrook Acres.

Bay Tree originally consisted of 25 single lots and 175 townhouse lots. (Tr. pp. 805, 806) He sold the single lots, and built townhouses on the remaining lots. As interest rates rose, he found himself with 35 completed but unsold townhouses which are the subject of the transactions at issue. Two of these were held in his own name, the rest were owned by Darby Development Company of which he was sole owner. Mr. Darby had outstanding construction loans on these properties tied to the prime rate which was running as high as 21%. (Tr. pp. 807, 811, 812)

The Oakfield development consisted of nine townhouses similar to those at Bay Tree. Title to these properties was held by MD Investment, a partnership between Mr. Darby and Curtis Martin, a builder. As was the case with Bay Tree, Mr. Darby could not sell these units because of high interest rates. At the same time, he was burdened with construction loans tied to the prime rate. (Tr. p. 812)

Mr. Darby needed to obtain permanent financing at a lower rate. In mid-1982, he learned that FHA money was available at the rate of 12% from Howard Russell of Standard Federal Savings and Loan. (Tr. p. 815) He also knew that Mr. Garvin was able to obtain FHA permanent financing for duplex projects. In mid-1982, he asked Mr. Garvin how it was done. Mr. Garvin explained the Mid-South financing methods, and told him that it had HUD approval. (Tr. pp. 812, 813, 819) Mr.

Darby had done business with Mr. Garvin for many years and never had any reason to question Mr. Garvin's integrity. (Tr. pp. 819-821) At this time Mr. Darby had been trying to arrange permanent financing from Cambridge Mortgage Company. After learning of Mr. Garvin's method he asked Cambridge to arrange permanent financing for Bay Tree and Oakfield. Cambridge experienced difficulties in completing the applications and frequently resorted to Mr. Garvin for assistance. (Tr. pp. 702, 703, 774, 775) Mr. Garvin decided it was easier to do it himself rather than explain the process to Cambridge. (Tr. pp. 702, 703, 774, 775, 815)

Following the Mid-South examples, Mr. Darby completed seven applications in his own name.[28] (Tr. p. 816, Govt. Exs. G-32 (d) to G-37(d)) The remaining applications for Bay Tree and Oakfield were signed by individual Mid-South employees or Mr. Garvin as "mortgagors". (Tr. p. 816, Govt. Exs. G-1 (d) to G-31 (d)) These applications were completed as a favor to Mr. Darby by Mr. Garvin. No origination fees were paid to Mid-South. (Tr. pp. 703, 705)

The applications were completed in the following manner:

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[28] Seven sets of deeds evidence a transfer from his wholly owned company, Darby Development, to Respondent, and back to Darby Development. Respondent testified that the seven applications signed by him were the result of a mistake. These applications were prepared by Cambridge rather than Mid-South and were made out in his own name rather than Darby Development. In his dealings with Cambridge he often signed his own name on behalf of Darby Development. Since his relationship with local lenders was rather informal, he could later call up the lender and indicate the entity which would acquire the title. In this case, he did not realize his mistake until after HUD issued its commitments. Time being of the essence in order to secure financing, he decided not to wait for three additional weeks for HUD to issue a commitment in the name Darby Development. Although admittedly improper, using himself as the "borrower" saved time. (Tr. pp. 816-818)

1. Blocks 8 (a) and 24 (m) set forth the amount of the loan as determined by the HUD appraisal.

2. Block 9 (a) which requests the borrower to state the purpose of the loan was checked "refinance".

3. Block 9 (b) which asks the borrower to state his intended relationship to the property is checked "landlord".

4. Block 15 (the estimated monthly payment) exceeds the amount listed in Block 23 (the estimated income from the property to be "refinanced"). Thus a shortfall is clearly stated on the form.

5. Blocks 21 and 22 list the assets and liabilities of the individual Mid-South employee, Mr. Garvin, or on the seven applications which Mr. Darby, himself, signed the assets and liabilities of Mr. Darby.

6. Block 24 lists the individual cost items comprising the total estimated cost. Block 24 (f) states the word, "refinance". Except for the individual Darby applications, next to this word is the phrase, "pay off const. loan". (Govt. Exs. G-32 (d) to G-37 (d))

7. Block 31 (a)(1) which asks whether the borrower owns or has sold other real estate within the last 12 months is answered "yes" with regard to ownership and "no" with regard to whether it is to be sold.

8. Block 31 (a)(3) specifically incorporates the Rule of Seven. The application asks whether if the dwelling is to be rented it is part of, adjacent or contiguous to any project, subdivision, or group rental properties involving eight or more dwelling units in which the borrower has a financial interest. In each case this block is checked "no".

9. Block 33 requiring the certification that the information contained in Section II is true and complete to the best of the borrowers knowledge and belief as well is signed by the "borrower".

The applications were signed on various dates between September and November of 1982. HUD issued firm commitments in the names of Lonnie Garvin, Jr., R. Gordon Darby, and Mid-South employees, Porter Kinard, Watson Chamberlin, and Eugene Garvin. The loan closings took place in January 1983. Standard Federal Savings and Loan issued the mortgages. Respondent did not make the investment in the property he would have been required to make had the transactions been treated as purchases.[29] Most of the loan proceeds were used to pay off construction loans. The excess amount remaining after paying off the loans was endorsed over to Mr. Darby or Darby Development Company. (Tr. p. 94, Govt. Ex. G-95) This amounted to $529,000. (Tr. p. 155, 162-165, Govt. Ex. G-95)

The properties were "transferred" from Darby Development, Inc., to the Mid-South employee, Mr. Garvin or Mr. Darby and from that individual back to Darby Development, Inc. The mechanism used for the "transfers" was a deed. Each deed contains the following language:

> (Grantor) in the State aforesaid, for/and in consideration of the sum of five and 00/100 ($5.00) dollars and assumption of the hereinbelow described mortgage to it in hand paid at and before the sealing of these presents, by (Grantee) in the State aforesaid, and (the receipt whereof is hereby acknowledged) have granted, bargained, *sold* and released, and by the Presents to grant, bargain, *sell* and release, unto the said (Grantee), his heirs and assigns, the following described property. . . ."

(Emphasis added) (Govt. Ex. G-91)

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[29] The record does not establish, nor does Respondent contend, that any funds invested he invested in the Bay Tree or Oakfield properties, prior to obtaining the firm commitments, i.e., payments on the construction loans, were sufficient to meet the minimum investment requirement.

One set of deeds reflects that the property was sold to the "borrower" prior to the respective closings. Another set shows that the new owner sold the property back to the original owner approximately three weeks after closing. For example, Darby Development, Inc., sold Porter Kinard the unit at 662 Swinton Court in Bay Tree on January 29, 1983. The property closed on January 31, 1983. Another deed reflects that Mr. Kinard sold the property back to Darby Development, Inc., on February 21, 1983. (Govt. Exs. G-16 (h), G-91)

II. Parkbrook Acres

Parkbrook Acres was a combination of three projects located in three separate subdivisions, Millbrook, Gadsden Acres and College Park. (Tr. p. 697) Millbrook was owned by Mr. Darby, Gadsden was owned by Tandem, and College Park was owned by a general partnership consisting of Mr. Darby and Tandem. (Tr. pp. 696, 697, 822) Two new partnerships were formed, Parkbrook Developers and Parkbrook Acres Associates. The development partnership consisted of Tandem and Mr. Darby. On the other hand, Parkbrook Acres Associates served as the syndication partnership. One per cent of the ownership was held by the general partners, Tandem, Mr. Garvin, and Mr. Darby. The remaining 99% was owned by limited partners. (Tr. pp. 699, 700)

The Parkbrook applications followed the method used for Mr. Garvin's Plantation Ridge. There were 52 properties involved in these transactions. (Govt. Exs. G-38 to G-89) The applications were submitted between August and November 1982. By that time HUD had approved approximately 160 applications for other similar projects. (Tr. pp. 207, 698) The deeds reflect sales from Parkbrook Developers to a Mid-South employee prior to closing. After closing, other deeds reflect sales from Mid-South employees to Parkbrook Acres Associates. (Tr. pp. 210-212, Govt. Exs. G-38 to B-89, G-91)) All deeds

were taken "subject to" the mortgage issued by Mid-South. Mr. Darby did not prepare the applications or act as "borrower" himself. On behalf of Parkbrook Developers, he signed not only deeds conveying the property, but also HUD Settlement Statements. For example, a deed showing a sale of Lot 144-A in Millbrook Subdivision from Parkbrook Developers to John E. Blackwell was executed on April 8, 1983. The deed was signed by Mr. Darby and Mr. Garvin for Parkbrook Developers. The closing also took place on that date. A subsequent deed, dated April 25, 1983, evidence a sale from Mr. Blackwell to Parkbrook Acres Associates subject to existing mortgages. (Govt. Ex. G-60) Parkbrook Developers "took out" $440,000 from these transactions.

Default and Workout Attempts

The Bay Tree, Oakfield and Parkbrook units were rented. However, things did not go as Mr. Darby and Mr. Garvin had planned. Changes to the tax law and the widespread use of low rate, tax exempt bonds resulted in increased competition for rental units in the Charleston area. (Tr. pp. 706, 707, 793, 826, 827) By 1986, Messrs. Darby and Garvin were faced with lower rents and destruction of the local rental market. This caused tenants to leave. A drop in the rate of inflation also affected the resale value of these units. Mr. Garvin's original economic assumptions proved to be wrong. Where he had expected a negative cash flow to continue for a few years, he had also expected the inflation rate to remain high, eventually generating a profit from the sale of the units. Now he and Mr. Darby were faced not only with a worsening cash flow, but now there was no end in sight because the inflation rate had come down. The Mid-South syndications continued to cover the operating deficits for Parkbrook. Mr. Darby had to cover Bay Tree and Oakfield himself. During the period from 1983 to September 1986, Mr. Darby spent $553,000 on Bay Tree and Oakfield. This combined with the effect of the depressed

market on his other properties caused him to lose $150,000 per month. (Tr. p. 829)

Mr. Darby contacted investor limited partners and his banks for financial assistance and arranged work-outs on his conventionally-financed properties. (Tr. pp. 829, 830, 857) He was unable to do this with Bay Tree and Oakfield since he and Darby Development, Inc., were the sole owners of the properties. Sometime in January 1986, Mr. Darby contacted the Deputy Manager of the HUD Columbia Office, Ron Rash. Mr. Darby proposed refinancing the loans since interest rates had dropped, otherwise he suggested there was a possibility he might be forced to default. (Tr. pp. 829, 831) Mr Rash told him that because of widespread "abuse" of the Rule of Seven, his office was not in a position to assist him. He suggested that Mr. Darby contact the HUD Regional Office in Atlanta.

Mr. Darby spoke with Timothy Raines, Director of the Program Support Division in the HUD Atlanta Office. Mr. Darby explained the financing arrangements surrounding the Bay Tree and Oakfield developments. He explained that loans had been originated in the name of employees and transferred to the Darby Development Company so that no person would have more than seven properties at a time. (Tr. p. 483) Mr. Darby argued that refinancing would benefit HUD since lower rates meant less risk of default. He also pointed out that under new rules, mortgage insurance premiums would be paid in a lump sum rather than over the period of the mortgage. During Mr. Darby's explanation of the financing arrangement, Mr. Raines recalls having heard Mr. Darby state, ". . . well we may have abused the program, but we didn't do anything illegal." He stated that he remembered this because it seemed to him to be quite "brazen". (Tr. p. 486) Mr. Darby's version of this conversation is that he was alluding to a characterization used by Mr. Rash in his previous conversation. Mr. Darby recalls

having said, "Y'all may think we abused the program, but we didn't do anything illegal." (Tr. p. 832) I find that Mr. Darby's version is the more likely of the two. Not only was he forthcoming to Mr. Raines about what occurred, but as an experienced businessman, it is unlikely that he would have made a statement, amounting to a taunt, when he badly needed HUD's help in extricating himself from his situation. Such "taunting" behavior is also inconsistent with the quiet, studied manner he displayed during his testimony at the hearing.

Mr. Garvin was also having problems. U.S. Shelter, the parent company of Mid-South, was experiencing financial difficulties. For a time it had funded the operating deficits, after the corporate general partners for the various Mid-South projects had stopped doing so. (Govt. Ex. G-93, p. 2) Mr. Garvin had been put on notice that U.S. Shelter might not be able to continue covering the operating deficits. (Tr. pp. 782, 783) He contacted HUD on January 6, 1986. At this time the loans were current. (Tr. 515, 782) In the Spring of 1986, U.S. Shelter went into default. (R. Exs. XX pp. 3, 5, 9-16, 21, 25) Shortly thereafter, U.S. Shelter requested HUD to accept an assignment of the single-family mortgages which would have resulted in an immediate claim payment of an amount in excess of $52,000,000. HUD refused to accept an assignment on legal and policy grounds.[30] The enormous potential financial loss resulting

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[30] Section 230 of the National Housing Act permits the Secretary to accept assignments only if: (1) the default was caused by circumstances beyond the mortgagor's control; and (2) the problem was temporary and could be corrected (interpreted by HUD to be within 36 months). It was the second ground which HUD determined could not be met. To heave accepted assignment, three policy changes would have resulted. These were: (1) to permit defaulted mortgagors to qualify under the assignment program because of reduced interest rates; (2) to legitimize the use of the single family program by investors including partnerships and corporations; and (3) to qualify as "circumstances beyond control" a situation where

from default and foreclosure caused the parties to seek some way of reaching an accommodation.

In order to structure a workout, avoid FHA insurance claims, and prevent the loss of the projects, Mr. Garvin began a negotiation process with HUD Headquarters which lasted the next two and one-half years. Traveling back and forth between South Carolina and Washington, D.C. at his expense, he met with senior HUD officials including the Assistant Secretary for Housing and the Deputy Assistant Secretary for Single Family Housing. (Tr. p. 780) Mr. Darby joined in these workout negotiations and spent over $6,000 in airfare alone. (Tr. p. 825)

A number of proposals were studied, considered, and rejected by HUD. One idea was to bring in outside financing with outside mortgagees. This would have released South Carolina National Bank and the other mortgagees. After this became unlikely there was also an attempt to work out an arrangement with South Carolina National Bank to hold the loan portfolio under a HUD approved mortgage modification agreement. (Tr. pp. 528, 529, Govt. Ex. G-144, p. 2) These proposals fell through because U.S. Shelter could not guarantee a sufficiently high interest rate. (Govt. Ex. G-144, pp. 2, 3, Tr. p. 528) Consideration was given to a plan whereby HUD would accept an assignment of the loans and enter into a workout and mortgage modification agreement with Mr. Darby and other partnerships. The Under Secretary of the Department rejected this proposal as he did not want to establish a precedent for doing this. (Tr. pp. 530, 568, Govt. Ex. G-144, p. 3) The fourth and last proposal was to refinance the entire portfolio under HUD's Section 223 (f) multifamily program. (Govt. Ex. G-144, p. 3) This was rejected because it would not be economically sound. (Govt. Ex. G-144, p. 9) The negotia-

an investor made an investment when the rental receipts were insufficient to cover operating expenses and full mortgage payments. (Govt. Ex. G-144, pp. 2, 3)

tions were terminated on September 19, 1988. The Assistant Secretary for Housing/FHA Commissioner, Thomas Demery, praised the parties for their efforts and cooperation. (R. Ex. XX, p. 37)[31]

Mr. Darby continued to manage and maintain the Bay Tree and Oakfield properties throughout this period. James Nistler, the former Deputy Assistant Secretary for Single Family Housing, testified that these properties were found by HUD to be the "best" built, maintained, and managed. (Tr. pp. 533, 534)

In October 1988, Mr. Garvin and Mr. Darby offered to tender deeds in lieu of foreclosure on the Bay Tree, Oakfield and Parkbrook properties. (Tr. pp. 536, 841) Ultimately 1600 properties were deeded to HUD for the amount of the outstanding debt, foreclosure actions were dropped, and the "borrowers" released from personal liability on the mortgage notes. (Tr. p. 717) Total claims in the amount of $6,475,466.22 were paid by HUD for the Bay Tree, Oakfield, and Parkbrook properties. (Tr. p. 340, Govt. Ex. G-155). As of the date of the hearing these properties remained in the HUD inventory. The properties have been maintained by HUD. This has amounted to an additional expense of $142,023.67. (Tr. p. 341, Govt. Ex. G-155) The present total "loss" on these

[31] The former Deputy Assistant Secretary for Single Family Housing testified on behalf of the Respondent. He had the following to say about the workout attempts:

> This particular case, in my opinion—and it got to be a football within my peers as to—if we were a bank and we had this problem, we would have sat down and worked it out. We had talked about the fact that we should admit that we made a mistake in the first place, make it so unique and so different, which it was, that it would never happen again. That was a scenario that went all the way up to the Under Secretary, to do this as a business decision—we made a mistake, let's fix it. At that time, my peers decided (1) it was too late because time had really run and (2) it wasn't the time and place to set a precedent.

(Tr. pp. 539, 540)

properties is $6,617,489.89. (Govt. Ex. G-155) As these properties should eventually be sold, the actual loss (or profit) is unknown.

A HUD audit of the Mid-South loan transactions was initiated by Mr. Nistler in the Fall of 1986. (Tr. pp. 126, 516-518, Govt. Ex. G-93, p. 3) The purpose of the audit was to discover if there had been any wrongdoing. The audit report concludes that there was no wrongdoing on the part of either Mr. Garvin or Mr. Darby, and that neither the HUD Columbia Office nor HUD Headquarters had been misled.[32] Concerning HUD's knowledge of the Mid-South transactions, the Report states:

> From our interviews and reviews of correspondence, we believe that HUD personnel in both Headquarters and the Columbia Office had sufficient knowledge to stop the scheme before or soon after it was initiated. However, they did not.

(Govt. Ex. G-93, p. 2)

HUD subsequently initiated an Inspector General investigation of the Mid-South transactions in 1988. John Coontz, the Deputy Director of Insured Single Family Housing, participated in the investigation, aware that he might testify as an expert witness in any resulting criminal prosecutions. (Tr. p. 294) Mr. Coontz subsequently recommended to the U.S. Attorney that there be criminal prosecutions. (Tr. p. 295) However, prosecution was declined. The prosecutor stated:

> The evidence does not show an intent of the part of the applicants or Mid-South Mortgage Company to commit a crime. The intent was to take advantage of a financing situation allowed by HUD officials for projects not feasible for conventional financing.

(R. Ex. NN)

[32] As discussed *supra*, the HUD Columbia Office, did, however, mislead HUD Headquarters.

Mr. Nistler, testified that HUD found no evidence of fraud, deception, deceit or intentional false statements (Tr. pp. 524, 525), or that the program was designed to fail. (Tr. p. 525) He also believed that both HUD offices were sufficiently aware of the relevant facts and approved what was being done.[33]

Mr. Darby has an excellent business reputation in the Charleston community. Until this case, he has never been threatened with sanctions or defaulted on any mortgage loan. (Tr. pp. 841, 842) His character and reputation were strongly vouched for by two witnesses at the hearing. The first, James Walker Coleman, is currently an Executive Vice President of Southern National Bank. (Tr. p. 497) He has thirty-nine years of banking experience and has known Mr. Darby for twenty-five years. Mr. Darby has been loaned millions of dollars by Mr. Coleman's banks. Mr. Coleman also testified that he knew of Mr. Darby's reputation in the community for truth and veracity, honesty and integrity. He stated that "I have absolute confidence in his integrity and his honesty." (Tr. p. 499) The second witness, Joseph C. Reynolds, is a mortgage banker with twenty-three years of mortgage banking experience. (Tr. p. 630) At the present time, he manages mortgage lending for South Carolina Federal Bank. (Tr. p. 631) He served as President of the Mortgage Bankers Association of the Carolinas and was Young Mortgage Banker of the Year in 1982. (Tr. p. 632) He has known Mr. Darby since 1971 and has had weekly, even daily, contact with him since that time. He has loaned Mr. Darby five to seven million dollars involving hundreds of single family loans. Like Mr. Coleman, he is familiar with Mr. Darby's reputation for truth and veracity, honesty and integrity in the community. He testified that his reputation is "well above board".

[33] While the HUD Columbia Office was aware of what had already happened, at the time it wrote to Mr. Abrams, HUD Headquarters was not.

At the time Mr. Nistler left HUD in March 1989, he was unaware of any sanctions being considered against Mr. Garvin or Mr. Darby. By this time, according to Nistler, ". . . we had already statutorily changed the programs to where in fact it couldn't be done again." (Tr. p. 540) The "investor program" for single family mortgages has been eliminated. (Tr, pp. 39, 278). Cash can no longer be "pulled out" of transactions. (Tr. p. 98, Govt. Ex. G-138)

HUD's imposition of an LDP on Mr. Darby was reported in the press. On August 23, 1989, HUD proposed a five year debarment based upon the Bay Tree and Oakfield transactions. Prior to that date, *The State*, a paper in Columbia, carried the headline, "S.C. Mortgage Ripoff is latest HUD Scandal." (R. Ex. DD) On November 16, 1989, the proposal was amended to include the Parkbrook allegations and to lengthen the duration of proposed debarment to an indefinite period.

Discussion

The Department has asserted that Respondent's actions with regard to the property transactions constitute grounds for debarment under 24 CFR 24.305(b), (d) and (f), and are adequate evidence to support the LDP under 24 CFR 24.705. Subsection (b) provides that a debarment may be imposed for:

> [v]iolation of the terms of a public agreement or transaction so serious as to affect the integrity of an agency program, such as:
>
> * * * *
>
> (3) A willful violation of a statutory or regulatory provision or requirement applicable to a public agreement or transaction.

Subsection (d) provides that debarment may be imposed for:

> [a]ny other cause of so serious or compelling a nature that it affects the present responsibility of a person.

Subsection (f) provides that a debarment may be imposed for:

> material violation of a statutory or regulatory provision or program requirement applicable to a public agreement or transaction including applications for . . . insurance or guarantees, or to the performance of requirements under a . . . final commitment to insure or guarantee.

Section 705(a) of Title 24 of the Code of Federal Regulations lists several causes for LDPs. Among those the enumerated causes are (7) false certification in connection with a HUD program, (8) commission of an offense under Section 24.305, (9) violation of a law or regulation or procedure relating to an application for insurance, and (10) making or procuring false statements for the purpose of influencing an action of the Department.

Based upon the voluminous record in this case, and the findings of fact set forth above, I conclude that despite the complicity of certain components of the Department, the Mid-South financing program used by Respondent was a sham which improperly circumvented the Rule of Seven. False information was provided on the applications for Section 203(b) financing in order to effectuate the sham. By characterizing each transaction as a "refinance" rather than a "sale" on the applications, Respondent was able to avoid the minimum investment requirements of the single family mortgage insurance program. Finally, effectuation of this sham necessarily avoided the requirements of the multifamily mortgage insurance program.

Respondent's acts constitute grounds for an LDP under 24 CFR 24.705(a)(7), (8), (9), and (10) and for de-

barment under CFR 24.305(b), (d) and (f). However, mitigating circumstances militate against imposition of a debarment for an indefinite period.

I.

Despite the "innovative" nature[34] of the Mid-South financing program, Respondent's use of the program violated a key program requirement of the single family program, the Rule of Seven. From the outset, the intended beneficiary of the financing was Respondent, through Darby Development, MD Investment or the Parkbrook syndicate. Neither Respondent nor these three entities in which he had an interest could apply for financing for more than seven units in their own names because of preclusion by the Rule of Seven. Hence, he used applicants/borrowers who, in their individual capacities, temporarily held title to no more than seven properties at one time and who applied on Respondent's behalf.[35]

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[34] According to Respondent, Mr. Garvin's Mid-South financing program, upon which he structured his financial transactions with HUD, was "an innovative financing program" conceived to develop needed rental housing at a time when HUD had reduced its involvement in multifamily housing. (Resp. Brief, pp. 7-8) The program was indeed creative and unusual, but nonetheless, improper. As a matter of fact, the preamble to the Department's waiver regulation discussed *infra* uses the phrase "innovative" to described untested financing proposals of questionable feasibility.

[35] Respondent takes issue with Department's use of the term "strawbuyer". He also contends that the Department has not identified any violation of law, rule, or regulation by the use of the so called strawbuyers. (Resp. Brief, p. 70) Respondent also argues that use of a strawbuyer is cause for debarment only where the "strawbuyer" is used to "hide the real or ultimate title holder." (*Id.* at 71-72) Use of "strawbuyers" was not cause for debarment in this case, according to Respondent, because the persons who signed the applications were not used to "hide from HUD the identities of the real parties in interest or their role or function in the financing program." (*Id.* at 72)

Respondent's argument is specious because the applications were indeed completed in such a way as to "hide", on their face, the identity of the "real or ultimate title holder". Regardless of what name is attributed to the applicants/borrowers, common sense dictates that their use was fundamentally improper because their involvement was for the sole purpose of obtaining federally insured mortgages, the benefits of which ran to individuals and entities which could not have obtained that mortgage insurance.

Because of Respondent's sophistication and experience with HUD single family and multifamily programs, he knew or should have known that the Mid-South program violated the Rule of Seven.[36] Respondent's acknowledgment that the proposed mortgage loan transactions "did not quite fit" HUD's application form is further evidence that Respondent knew or should have known that the program was a sham. (Resp. Brief, pp. 74, 75) The applications in their entirety could not be completed accurately to reflect the nature and terms of the transactions. This constituted a "red flag" that use of the single family program as he intended was impermissible.

By violating the Rule of Seven, Respondent contravened the spirit and intent of the single family program. The mass defaults and consequent placement of large numbers of properties insured under the single family program into the HUD inventory which occurred as a result of Respondent's use of the Mid-South financing program was exactly what the Rule of Seven was designed to prevent.

II.

Block 9(a)

Effectuation of the sham could only be accomplished by temporary passage of title to the so-called borrowers and the resultant falsification of the applications for single family mortgage insurance. Respondent characterizes the temporary passage of title to and from the applicants/borrowers as a "refinance". This characterization is false

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[36] Indeed, another builder, on the advice of his attorney, questioned the legality of the Mid-South financing method as a violation of the multifamily rules and regulations. (Tr. pp. 379-80)

for two reasons. First, the transactions constituted, in fact, two separate sales rather than one refinance. Second, an applicant cannot apply in his own name to refinance a construction loan on behalf of another. Thus, Block 9(a) should have been completed to reflect that purchases occurred.

Respondent views the two "transfers" as one overall transaction, i.e., the "complete financing program".[37] (Resp. Brief, p. 79) In reality, however, there were in fact two distinct transactions,[38] each constituting a sale and having its own, yet an identical, legal effect. Throughout this proceeding, Respondent has identified the trans-

[37] In th Amended Answer to the Amended Complaint at 8, Respondent stated that "beneficial ownership" was "vested in" either Respondent, his corporation, or partnership "at all relevant times" and that "legal title" was "temporarily held" by other persons to comply with the Rule of Seven. Respondent did not identify the theory for this "beneficial ownership" and "temporary" holding of "legal title". This argument was not pursued beyond the Answer, and there is no evidence to support it. Even if "equitable title" were vested in Respondent, his corporation or partnership, the applications were completed by the "legal title" holder. As discussed below, the applications therefore should have reflected the method by which the "legal title" holder obtained his/her interest in the property. Sale, rather than refinance, was that method.

Moreover, Respondent's use of both the "legal/equitable title" theory and the "transfer" concept advanced in the brief to describe and justify the "temporary" passage of title to Respondent, Mr. Garvin or the Mid-South employee is a creative, but inaccurate, description of the transactions and demonstrates his recognition that he had to establish some legal relationship between the applicant and the property. It further demonstrates his grappling to describe the legal effect of the transactions as anything but sales.

[38] For the Bay Tree and Oakfield developments, there were two distinct transfers of title: from Respondent's wholly-owned corporation to himself, Mr. Garvin, or a Mid-South employee and back to that corporation. For Parkbrook Acres, there were also two distinct transfers, namely, a transfer of title from Respondent's corporation to the Mid-South employee, and one from the employee to the syndicate.

actions, which were represented by deeds, as "transfers" which were the effective means by which title was passed. "Transfer", however, is a generic term having no independent legal significance. Only specific types of transfers may operate to pass title.

An individual may acquire property only by one of the methods prescribed by law. 73 C.J.S. *Property* Sec. 32 (1983). Those methods are "descent, that is hereditary succession, and "purchase", that is, acquisition obtained by way of bargain and sale, for money, or some other valuable consideration, or other than by descent. J. W. Ehrlich, *Erlich's Blackstone* 244, 266 (1959); *see also* 5 Thompson on Real Property Sec. 2395 at 191 (1979 Replacement Vol.). Since descent is not involved in this case, the acquisitions had to have been by purchase. "Purchase" includes five methods of acquiring title: escheat, occupancy, prescription, forfeiture and alienation. *Erlich's Blackstone*, *supra*, at 268. Obviously, the transfer of title in this case was accomplished by alienation. This is the conveyance or purchase of property in its limited sense, *i.e.*, any method whereby property is voluntarily resigned by one person and accepted by another, whether "effected by sale, gift, marriage settlement, devise, or other transmission of property by the mutual consent of the parties." *Id.* at 295. Regardless of the method employed, the transfer must be properly evidenced in order to prevent disputes as to the existence and terms of the transfer. *Id.* at 300. The legal evidences in this case were deeds. *Id.*

Respondent argues that the "transfers involved parties that had a complete and common identity of interest, *i.e.*, to complete a permanent financing transaction which had been disclosed to and approved by HUD." (Resp. Brief, p. 79) However, an individual cannot transfer title to property for the sole purpose of "completing" a financing transaction without employing one of the above-described legal methods for passing title. In this

case, the legal evidences of the "transfers" were identical deeds which specifically state that the properties were *sold*[39] for consideration of five dollars. The deeds contain specific language of bargain and sale and are valid on their face.[40] Under South Carolina law, where a deed is valid and regular on its face, it is presumed to be valid in all respects. *Davis v. Monteith*, 345 S.E. 2d 724, 727 (S.C. 1986). Thus, both sets of transfers were accomplished by sale.

Respondent's argument that the "transfers" to his corporation or to the syndicate were not sales ignores the legal effect of the deeds of sale. Upon signing the deeds, the legal rights of the parties changed. The "borrowers", however temporary their status, became legally obligated on the notes and owned the property in fee simple. Similarly, the subsequent transfer of the properties again changed the rights of the parties.[41]

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[39] For the Bay Tree properties that were the subject of the seven applications signed by Respondent, there were two sets of deeds of sale transferring title—from his corporation to himself, and back to his corporation. Even assuming the construction loans for those seven properties were taken out by Respondent and not his corporation, Respondent's statement that the purpose of the loans was "refinance" was also incorrect because the "transfers" were sales, identical to the sales involving Mr. Garvin and the Mid-South employees.

[40] Rather than relying on the language of the deeds in addressing the sale/refinance issue, the Department relies on the principle that an applicant cannot refinance another person's debt. Essentially, the Department argues that the purpose of the loans was "sale" because it was not "refinance". To argue that the transactions were not refinances, however, begs the question. The conclusion reached in this decision is based on the express language of the deeds and the proper legal characterization of the transactions themselves.

[41] Respondent argues that the second set of "transfers" from Respondent and the Mid-South employees to his corporation or the syndicate were not sales because, *inter alia*, there was no arms-length dealing or "consideration paid or received". (Resp. Brief, p. 79) In fact, the second set of deeds recites the same consideration as the first set. If the second set of "transfers" were not sales, the

Respondent's additional argument that an applicant could refinance another person's loan is specious. As a general matter, refinance means to "finance again or anew." Black's Law Dictionary, 5th Ed., 1979, at 1152. The Department correctly argues that "[o]bviously, one cannot finance for a second time that which one has yet to finance for the first time." (Govt. Brief, p. 23) Moreover, if Respondent's argument were correct and it were permissible for an applicant to apply for a mortgage on behalf of another person, HUD would have no way of assuring that the "true" applicant satisfied all the requirements for issuing insurance, including a demonstrated ability to repay.

Although the transaction was structured in such a way that title passed to the "borrower" prior to closing, the transaction was nonetheless a sale and Block 9(a) incorrectly stated that the purpose of the loan was a "refinance". Due to the unique and artificial nature of the financing program, whether title passed at or before the closing is irrelevant to the description the "applicant" should have given to the purpose of the loan. Thus, the purpose that should have been stated on the application was the purchase of property.[42]

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first set could not have been sales and title would never have passed to the temporary purchasers in the first place.

Moreover, under South Carolina law, mere inadequacy of consideration will not justify cancellation of a deed absent fraud or undue influence. *Atkinson v. Belser*, 255 S.E. 2d 852, 855 (S.C. 1979). Respondent does not assert, nor is there evidence, that fraud or the exercise of undue influence was involved and therefore there is no evidence supporting cancellation of the deeds.

[42] In Block 9 (a), there are several sub-blocks relating to "purchase". For the Bay Tree and Oakfield properties, the applicants/mortgagors should have checked sub-block 6 "purchase existing home not previously occupied". For the Parkbrook properties, the applicants/mortgagors should have checked sub-box 7 "construct a home—proceeds to be paid out during construction", which implies a "purchase".

Blocks 9(b), 31(a)(1) and 31(a)(3)

Block 9(b) asks the applicant to state his intended relationship to the property. Respondent contends that the "landlord" block was appropriately checked

> because it most accurately described the *end result* of the mortgage loan transaction,—i.e., the owner/borrower would own and operate the property as investor-owner who would indeed be a landlord and thus the FHA-insured loan was to finance a rental property.

(*Resp's Brief*, p. 77) (Emphasis added)

Respondent's argument, however, does not focus on the appropriate person's "end result". In order to have any meaning and to be reliable, the form must correctly identify what the *applicant's* relationship to the property will be, not some unnamed entity. It is undisputed that the "applicants" did not intend to be landlords of these properties. Indeed, because Block 33 requires the signature of the "borrower" and was signed by either Respondent, Mr. Garvin, or a Mid-South employee, Respondent cannot argue that the term "borrower" used in Box 9(b) referred to anyone other than the person signing the form, the "applicant". The fact that there was an oral disclosure to certain HUD employees of the intended landlord (Respondent's corporation or syndicate) does not make the written statement true. Furthermore, the written statement could not be relied upon by anyone not aware of the actual facts surrounding the transaction.

Moreover, Respondent chose which person's "end result" (the applicant or the ultimate owner) applied to suit his purposes. This resulted in the answers given in Blocks 9(a), (b) and Block 31(a)(1) (which answers "no" to the question of whether the property was owned or sold within the last 12 months is to be sold) that were inconsistent with the answers to Block 31(a)(3) (which asks whether the property was part of, adjacent to or

contiguous to any properties involving eight or more units). The first set of blocks was answered as if the ultimate owners were the relevant subjects. The second set, however, was answered as if the temporary purchasers were the relevant subjects. Respondent cannot have it both ways. Had the applicants answered Block 31(a)(3) consistently with Blocks 9(a), 9(b) and 31(a)(1), the applications would have contained unmistakable violations of the Rule of Seven, and they would not have been approved.

The answers to these blocks were false. Therefore, Respondent submitted and caused others to submit false statements on the Section 203 applications.[43] The false statements enabled Respondent to obtain financing to which he was not entitled. Respondent asserts that the Department did not rely upon the statements because Mr. Garvin made a sufficient disclosure. Although the ma-

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[43] Respondent argues that a Section 203 applicant does not certify his answers to Sections I, which includes Blocks 9(a) and 9(b), but rather certifies the accuracy of the personal and financial information in Section II (relating to the disclosure of an applicant's assets and liabilities). (Resp. Brief, pp. 75-76) In that regard, Respondent further argues that "HUD loan processors have the responsibility of checking and, if necessary, correcting the accuracy of the information provided in the applications." (*Id.* at 76). Whether or not HUD is responsible for verification of the information is irrelevant: the applicant is in the first instance responsible for submitting accurate information. It defies logic to argue that simply because of the absence of a certification which expressly applies to particular information, an applicant may ever submit false information on a government form in order to obtain benefits.

Further, as Respondent fails to note, Section V, Block 33 contains the directions: "[b]efore signing, review accuracy of application and certifications". That direction applies to all the statements made by the "borrower" in the application. Moreover, following Block 33, the application form sets forth in bold print the warning that, inter alia, any "intentional misrepresentation . . . purposed to influence the issuance of any . . . insurance by . . . HUD . . ." violates federal laws which provide severe penalties.

terial facts were disclosed to isolated HUD employees and, therefore, there was no evidence of fraud, the statements were indeed false and were known to be false. Had the applications not been completed in this manner, HUD Columbia could not have approved the applications, including its calculation of the mortgage amount based on the stated purpose of the loan.

III.

Because the transactions were sales, Respondent was required, but failed, to satisfy the minimum investment requirements. By identifying the purpose of the loan on the HUD forms as a "refinance", Respondent was entitled to borrow more money than he would have if he had identified it as a "purchase" and obtained a cash surplus from the mortgage amounts.

IV.

Debarment is a sanction which may be invoked by HUD as a measure for protecting the public by ensuring that only those qualified as "responsible" are allowed to participate in HUD programs; *Stanko Packing Co. v. Bergland*, 489 F. Supp. 947, 949 (D.D.C. 1980); *Roemer v. Hoffman*, 419 F. Supp. 130, 131 (D.D.C. 1976). "Responsibility" is a term of art used in government contract law. It encompasses the projected business risk of a person doing business with HUD. This includes his integrity, honesty, and ability to perform. The primary test for debarment is present responsibility although a finding of present lack of responsibility can be based upon past acts. *Schlesinger v. Gates*, 249 F.2d 111 (D.C. Cir. 1957); *Roemer, supra.* The debarment sanction may also be justified on the basis of its deterrent effect on those who do business with the government.

The Department proved by preponderant evidence that there are grounds for debarment under 24 CFR 305(b), (d) and (f).[44] Respondent placed extensive public funds at risk when he knowingly used the sham financing program. Further, in connection with making false statements on the applications, he demonstrated a lack of forthrightness in his dealings with the government. The Department has, therefore, established by preponderant evidence that Respondent lacks present responsibility. In addition, debarment will serve to deter both him and others from taking similar actions.

Specifically, Respondent willfully and materially violated statutory and regulatory provisions and program requirements and he may therefore be debarred under 24 CFR 305(b) and (f). In using the Mid-South financing program, Respondent knowingly violated the HUD regulation setting forth the single family program's Rule of Seven. Respondent also knowingly avoided the procedures and requirements applicable to the multifamily program. He also knowingly violated the single family program's minimum investment requirements.

Respondent's actions are also cause for debarment under 24 CFR 305(d). That subsection, which concerns present responsibility, is broad enough to include the making of false statements on applications for FHA insurance.[45] Those falsities were the means by which the sham financing program was effectuated.

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[44] This finding subsumes a finding for imposition of the LDP under the basic evidentiary standard of "adequate evidence". *See* 24 CFR 24.705(a)(8).

[45] Respondent relies on the HUD Board of Contract Appeals' Determination in *Wayne C. Sellers*, HUDBCA No. 88-1295-DB (LDP) and 88-1305-DB (Aug. 2, 1989). This Determination interpreted subsection (d)'s enumeration of specific grounds for debarment as limiting the application of that subsection to those grounds. Accordingly, Respondent contends that subsection (d) does not apply because "Respondent's conduct does not even remotely fit within the enumerated causes. . . ." (Resp. Brief, p. 75 n.4) That Determination, however, was reversed by the Secretary's designee on October 31, 1989. The Secretary's designee found that applicability of subsection (d) is not limited to causes similar to those enumerated in that subsection.

Once the applications were falsified, they failed to reflect the true nature of the transactions. Thus, anyone not knowing the actual facts would be unable rely upon them. The Department and the public must be able to rely upon the accuracy of the written representations made to it. It is impermissible for one doing business with the government to provide accurate information orally to isolated government employees regarding a transaction, and misinformation regarding the same transaction in a writing held out to the government and the public.

The Department failed to prove by preponderant evidence, however, that Respondent's defaults are grounds for debarment. The Department argues that Respondent allowed the HUD insured mortgages to default because he thought that the Department would not attempt to collect any deficiencies. (Govt. Brief, p. 65) It further relies upon Respondent's success in avoiding foreclosure of his conventionally financed properties.[46] As discussed below this contention is without merit because Respondent made good-faith efforts to negotiate a work-out with HUD to avoid foreclosure.[47]

VI.

Respondent argues that the government should be estopped from debaring him because of the doctrine of equitable estoppel. Estoppel is an equitable doctrine in-

[46] The Department also argues that the $6000 which Respondent spent on plane fare in order to negotiate a work-out would have been more appropriately applied to the mortgage indebtedness. (Govt. Brief, p. 65) The Department's argument is counterproductive; it would discourage individuals from making good-faith attempts to avoid foreclosure and make good on their debts.

[47] The Department argues that "the real reason for Respondent's eagerness for his attempt to obtain a work-out was not for the Department's benefit but to avoid tax losses on depreciation and to protect the interests of the limited partners in the Parkbrook syndication." (Govt. Brief, p. 66) Even if true, however, this would not denigrate his good-faith efforts to obtain a work-out.

voked to avoid injustice in particular cases. *Heckler v. Community Health Services*, 467 U.S. 51 (1984), *reh'g denied*, 475 U.S. 1061 (1986). In *Heckler*, the Court left open the question of whether estoppel can ever be applied against the government. This question, however, need not be reached. For the reasons below, this case does not present a situation where application of the doctrine is appropriate.

The doctrine of equitable estoppel is applied against any party, whether private or the government, only when the following traditional elements are present.[48]

> If one person makes a definite misrepresentation of fact to another person having reason to believe that the other will rely upon it and the other in reasonable reliance upon it does an act that would not constitute a tort if the misrepresentation were true, the first person is not entitled . . . to maintain an action of tort[49] against the other for the act. . . .

Restatement, Torts, 2d Sec. 894(1) (1979). To be reasonable, the party claiming estoppel must not have known, nor should it have known, that the government's conduct was misleading. *Heckler*, 467 U.S. at 59.

[48] The Court in *Heckler* stated that "the Government may not be estopped on the same terms as any other litigant." 467 U.S. at 60-61. Some courts, including the Fourth Circuit, have held that, assuming the government may be estopped in an appropriate case, the private party must, at a minimum, also establish that the government engaged in some "affirmative misconduct". *See, e.g., Zografav v. V.A. Medical Center*, 779 F.2d 967, 969-70 (4th Cir. 1985). Because, as discussed below, Respondent failed to establish the traditional elements of estoppel, the issue of whether HUD's conduct in this case constituted affirmative misconduct need not be reached.

[49] Although the LDP and proposed debarment are not tort actions, they are analogous in that they attempt to correct a wrong committed against the party bringing the action.

Respondent's reliance on the representations[50] made by HUD[51] regarding the permissibility of the Mid-South financing program was unreasonable.[52] As stated, above, because of Respondent's sophistication and experience in HUD's single family and multifamily programs, he knew or should have known that the financing program violated the spirit and intent of the single family program, including the Rule of Seven and the minimum investment requirements. Under those circumstances, Respondent cannot hide behind the fact that government employees approved the program when he, in the first instance, knew or should have known that it was improper.

As stated in *Heckler* at 63,

> Protection of the public fisc requires that those who seek public funds act with scrupulous regard for the requirements of law; respondent could expect no less than to be held to the most demanding standards in its quest for public funds. This is consistent with the general rule that those who deal with the Government are expected to know the law and may not rely on the conduct of Government agents contrary to law.

[50] Mr. Granat and Mr. DesChamps of the HUD Columbia Office and Ms. Ruth Studer of HUD Headquarters Single Family Division, Mortgage Credit Section were the HUD personnel who represented to Mr. Garvin that the Mid-South financing program was permissible. Although initially these persons were told neither that the original owners of the properties would ultimately obtain the properties back through other entities in which they also had interests nor that the transactions would be characterized as "refinances," Messrs. Granat and DesChamps and Ms. Studer knew enough about the program from the other information made available to them that they should have not given their imprimatur to the program.

[51] Respondent's reliance upon representations that HUD employees had approved the Mid-South program was not based upon any direct contact he had with these employees. It was based on Mr. Garvin's assurances that the financing program met with HUD's approval and HUD Columbia Office approval of the applications submitted by Mr. Garvin.

[52] The Department also argues that Respondent is not entitled to equitable estoppel because his "hands are far from clean." (Govt. Brief, p. 46) Because I find that Respondent's reliance was unreasonable, it is unnecessary to apply the doctrine of unclean hands in this case. Moreover, I need not decide whether Respondent demonstrated the other elements of estoppel.

Before using the "innovative" financing program which was intended to avoid a key program requirement and which placed a great deal of public funds at risk,[53] Respondent should have prepared a written proposal for review and received a written confirmation prepared on or on behalf of the Secretary or Assistant Secretary for Housing. As noted by the Court in *Heckler*, the requirement of a writing serves two purposes: to avoid fraud and to foster well-reasoned decisionmaking subject to the possibility of review. 467 U.S. at 65. Any reasonable and prudent businessman in Respondent's shoes would have obtained appropriate written approval prior to using the program. Reliance upon oral advice from the local office or from a staff employee at Headquarters on an issue of this complexity was anything but reasonable.[54] As in *Heckler*, both Respondent's failure to obtain written approval and his failure to do so from the appropriate source undermined Respondent's reliance.[55]

[53] This was accomplishd because Respondent not only received public funds, but also subjected those funds to speculative market forces, including the assumption of an eventual lowering of interest rates and continued high inflation.

[54] Ms. Studer, the Headquarters employee who responded that the financing program was permissible, was only one of two staff employees in HUD Headquarters responsible for answering questions from the field relating to the single family program. Because the financing program did not satisfy the Rule of Seven, Ms. Studer, as well as anyone in the HUD Columbia Office, lacked the authority to approve the financing program. Thus, the unreasonableness of Respondent's reliance is further demonstrated by the fact that insofar as the misrepresentations were made by HUD, they were not made by an authorized official.

[55] As the minimum investment requirement is mandated by statute, Respondent could not have obtained an exception from that

Regulatory changes concerning waivers of eligibility requirements underscore the unreasonableness of Respondent's reliance. Since October 6, 1982, there has been in effect a regulation expressly providing for waivers of eligibility requirements under the single family program. 47 Fed. Reg. 35957 (Aug. 18, 1982). Section 203.248 of Title 24 of the Code of Federal Regulations provides that

> The Secretary in an individual case may waive any requirement of this subpart (except [sections] 203.1 through 203.9) not required by statute if the Secretary finds that application of such requirement would adversely affect achievement of the purposes of the Act. Each such waiver shall be *in writing* and supported by a statement of the facts and grounds forming the basis for the waiver. The authority under this section may be delegated to the Assistant Secretary for Housing—Federal Housing Commissioner, but shall not be redelegated.

(Emphasis added)

On April 6, 1982, HUD published this regulation as a proposed rule in the Federal Register. The proposed rule was identical to the final rule, which was published on August 18, 1982. *See* 47 Fed. Reg. 35957. In the preamble to the final rule, the Department noted that

> [i]n adopting this final rule, HUD intends that the new waiver procedure be available in individual cases to prevent undue hardship to homebuyers resulting from new or changed market conditions; to test the feasibility of an innovative financing proposal; or to solve a unique housing problem. . . . HUD emphasizes that its waiver authority is not intended to be utilized for "end runs" around the rulemaking process. Waivers will be considered only in

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requirement. Basing his conduct upon representations that he could do so further underscores the unreasonableness of his reliance.

> special circumstances and will be granted only in limited cases. . . .

Id. at 35957-58.

This regulation was not in effect when Mr. Garvin first approached the HUD Columbia Office with his financing program proposal. However, Respondent submitted applications at various times pursuant to the Mid-South financing program: (1) after the proposed rule was published for notice and comment but before publication of the final rule; (2) after the final rule was published, but not yet effective; and (3) after the effective date of the regulation.

While Respondent is not being held responsible for a failure to utilize the waiver regulation, he knew or should have known of its publication as a proposed and final rule and taken appropriate action. When the proposed rule was first published, he was on notice that the Department was considering the procedures for obtaining exemptions from regulatory requirements where an "innovative financing proposal" was involved. Those procedures included written action at the Secretarial level. It is contrary to an assertion of reasonable reliance that Respondent failed to write to Headquarters to ascertain the ramifications the new regulation would have on his use of the financing program.

It should be noted that the Department is far from blameless for its part in the events which led to formulation and implementation of the Mid-South financing program. The Department's complicity is evident. It began with the HUD Columbia Office's approval of the financing program, including its having based that approval on the advice of a Headquarters employee rather than a high-level official and the inexplicable failure by the head of that office to take timely action regarding that program. It continued through the Columbia Office's disre-

gard of the memorandum from Headquarters advising of the impropriety of the program.

Mr. Garvin explained the program in sufficient detail that Messrs. DesChamps and Granat and Ms. Studer should have recognized that the program violated the Rule of Seven. Mr. Corley knew that the program was being used and went so far as to tell another builder that Headquarters approved of its use. Mr. Corley either did not inquire as to the exact source and medium of that approval or was told that it was oral approval from a staff employee and viewed that as sufficient. As discussed *infra*, the HUD Columbia Office, if for no other reason than self-protection, should have sought written approval from appropriate high-level officials at Headquarters.

Despite the fact that the HUD Columbia Office had been receiving applications from Mid-South in bulk by the bus-load, that the employee responsible for processing the applications was "keeping score" to make sure no applicant owner more than seven properties, and that Mr. Garvin was corresponding with HUD requesting "substitution" of applicants, it was not until after the Director of Housing and Mr. Granat went out into the field that they became concerned. Even then, they were concerned with the extent to which the program had been implemented rather than the nature of the financing program itself.

Perhaps most troubling is that Mr. Corley should have, but did not, order his employees to hold in abeyance any applications submitted pursuant to the Mid-South financing program pending appropriate Headquarters' action. Instead, he belatedly requested guidance and advice from the appropriate official at Headquarters concerning the "proposed" financing program. That request was misleading, and demonstrated the HUD Columbia's Office's attempt to hide the fact that it had been approving applications submitted pursuant to the Mid-South financing

program all along. The failure to acknowledge that the program had already been implemented was only exacerbated by Mr. Corley's staff's continued issuance of final commitments where conditional commitments had been issued despite having been advised that the "proposed" program was impermissible.

VII.

HUD regulations provide that "[t]he existence of a cause for debarment . . . does not necessarily require that the person be debarred; the seriousness of the person's acts or omissions and any mitigating factors shall be considered in making any debarment decision. 24 CFR 24.300.[56] Respondent's acts were serious because they placed at risk a large number of properties and a great deal of public funds. Further, through use of the Mid-South financing program, Respondent caused others to submit false statements on official government documents on his behalf.

Despite the seriousness of Respondent's acts, however, mitigating factors exist which weigh against imposition of an indefinite debarment as requested by the Department. While use of the Mid-South financing program was improper and involved making false statements on the applications, there is no evidence of any intent to deceive the Department; most of the relevant facts were indeed disclosed to the HUD Columbia Office and a Headquarters employee. Thus, in obtaining mortgage insurance through the wrong program, Respondent did not defraud the government. Indeed, the United States Attorney declined criminal prosecution of Respondent because of lack of intent to commit a crime. The only intent the prosecutor found was "to take advantage of a financing situation allowed by HUD officials for projects

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[56] Similarly, the HUD regulations regarding LDPs provide that "[i]n each case . . . the decision to order a limited denial of participation shall be discretionary and in the best interests of the Government." 24 CFR 24.700.

not feasible for conventional financing." The lack of criminal intent, including an intent to defraud the government, militates against a period of debarment for 3 years or more. Under the circumstances, such a debarment would serve no legitimate purpose and, therefore, would be punitive.

Respondent did not conceive the Mid-South financing program: he simply saw and took advantage of a "good thing" that was already working for Mr. Garvin. Moreover, the program was not designed to fail; Respondent did not partake of the program to cheat the government out of money. Although Respondent was able to "pull out" excess mortgage proceeds, his corporation and the syndicate covered substantial operating deficits for several years, which essentially had the effect of "subsidizing" the rental property. Unfortunately for Respondent, his and Mr. Garvin's market assumptions were not realized. This prevented Respondent from ultimately selling the properties as single family housing and led to the defaults.

Most importantly, the extent to which Respondent genuinely cooperated with HUD to try work out his financial dilemma and avoid foreclosure weighs very heavily in his favor. His efforts in this regard were herculean and beyond reproach; between 1986 and 1988, Respondent negotiated with HUD over a possible work-out. (Tr. p. 834) He traveled to Washington, D.C. many times during that period and spent thousands of dollars in air fare. (Tr. p. 835) It was the Respondent who contacted HUD before the defaults occurred to discuss the problems and who went to extraordinary efforts to save the properties involved. In fact, the former Assistant Secretary for Housing/FHA Commissioner praised Respondent for his efforts and cooperation in exploring various alternatives to foreclosure. (R. Ex. XX, p. 37)

Respondent's cooperation in this regard is only further enhanced by the undisputed evidence of his reputation

for truth and veracity among reputable lenders in the community and of his exemplary performance as a builder and manager of housing projects. Until his defaults in this case, Respondent had never defaulted on any properties in his 28 years in the real estate business. Further, Respondent convincingly testified that:

> this thing has been one of the most traumatic experiences in my life, it's ruined my reputation. It was in the paper, newspapers. . . . Of greatest significance . . . is I can't do any more business with HUD.

(Tr. p. 842) Thus, Respondent appeared to genuinely regret the situation in which he placed himself.

Another factor which weighs in favor of mitigation is the passage of time. Respondent's acts at issue took place in 1982 and 1983; the LDP was issued and debarment proposed in 1989. By the time those actions were taken, the programs had been changed by statute to eliminate the "investor program" for single family mortgages.

Nonetheless, a debarment for a meaningful period is necessary to deter Respondent and others from acting similarly in the future. As a seasoned businessman well-versed in the single family and multifamily housing programs, Respondent knew or should have known that the financing program was improper. He should have taken the necessary measures to obtain appropriate Department clearance on his own behalf.

As stated by Justice Holmes in *Rock Island, A. & L. R. Co. v. United States*, 254 U.S. 141, 143 (1920), "[m]en must turn square corners when they deal with the Government." Although Respondent's personal honesty and integrity have not been implicated in his use of the financing program, by blindly following Mr. Garvin's financing program, his exercise of prudent business judgment has been called into question. A debarment of some

length is warranted to impress upon Respondent that he must act prudently when dealing with the government and to send a message to those who deal with the government that they, too, must act prudently in similar circumstances.

I find that Respondent should be debarred for a period of 18 months, beginning on June 19, 1989, the date on which the LDP was imposed. A debarment for 18 months is a serious sanction, commensurate with the seriousness of his acts. In light of the mitigating circumstances discussed above, however, a greater debarment period would be punitive.

Conclusion and Order

Upon consideration of the entire record in this matter, I conclude that the Limited Denial of Participation of Robert Gordon Darby is supported by adequate evidence. I also conclude that its duration of 1 year is appropriate to protect the public fisc and is in the public interest.

Upon consideration of the public interest and the entire record in this matter, I conclude that good cause exists to debar Ronald Gordon Darby, and his affiliates, Darby Development Company, Inc., Darby Realty Company Darby Management Company, Inc., MD Investment, Parkbrook Acres Associates and Parkbrook Developers, from further participation in primary covered transactions and lower tier covered transactions as either participants or principals at HUD and throughout the Executive Branch of the Federal Government and from participating in procurement contracts with HUD for a period of 18 months to run from June 19, 1989, the date of his limited denial of participation, to and including December 19, 1990.

/s/ William C. Cregar
WILLIAM C. CREGAR
Administrative Law Judge

Dated: April 13, 1990

APPENDIX E

ADMINISTRATIVE PROCEEDING IN THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

IN THE MATTER OF
ROBERT GORDON DARBY
DARBY DEVELOPMENT CO., INC.
DARBY REALTY CO.
DARBY MANAGEMENT CO., INC.
MD INVESTMENT
PARKBROOK ACRES ASSOCIATES
PARKBROOK DEVELOPERS

FINAL DETERMINATION

By letter dated August 23, 1989, Robert Gordon Darby was notified by certified mail that his debarment was being proposed based on causes under Title 24, Code of Federal Regulations, Sections 24.305(b), (d) and (f).

By an order dated April 13, 1990, Administrative Law Judge William C. Cregar issued a determination of debarment against Robert Gordon Darby and his affiliates for a period of 18 months from the date of a Limited Denial of Participation, June 19, 1989, to and including December 19, 1990.

Pursuant to the provisions of 24 CFR, Section 24.314 (g) this final determination imposes the debarment, cited above, and excludes Mr. Darby and his affiliates, Darby Development Co., Inc.; Darby Realty Co.; Darby Management Co., Inc.; MD Investment; Parkbrook Acres Associates; and Parkbrook Developers, from participation in covered transactions (see 24 CFR, Section 110(a)

(1)) at HUD and throughout the Executive Branch of the Federal Government and from participation in procurement contracts with HUD.

This determination shall have no bearing on future Departmental actions, if any, which may be based on facts not considered in this case.

Sincerely yours,

C. AUSTIN FITTS
Assistant Secretary for
Housing-Federal Housing
Commissioner

Dated Jun. 21, 1990

Washington, D.C.

cc:

G. Richard Dunnells, Esq.
Steven D. Gordon, Esq.
Dunnells, Duvall, Bennett
and Porter
2100 Pennsylvania Ave., N.W.
Suite 400
Washington, D.C. 20037

APPENDIX F

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 91-2113

R. GORDON DARBY; DARBY DEVELOPMENT COMPANY; DARBY REALTY COMPANY; DARBY MANAGEMENT COMPANY, INCORPORATED; MD INVESTMENT; PARKBROOK ACRES ASSOCIATES; PARKBROOK DEVELOPERS,
Plaintiffs-Appellees

v.

JACK KEMP, SECRETARY OF HOUSING AND URBAN DEVELOPMENT; C. AUSTIN FITTS, Assistant Secretary for Housing/FHA Commissioner; UNITED STATES OF AMERICA,
Defendants-Appellants

On Petition for Rehearing with
Suggestion for Rehearing In Banc

[Filed March 20, 1992]

The appellees filed a petition for rehearing with suggestion for rehearing in banc. No member of the Court requested a poll on the suggestion for rehearing in banc, and the original judicial panel voted to deny the petition for rehearing.

The Court denies the petition for rehearing with suggestion for rehearing in banc.

Entered at the direction of Judge Wilkins, with the concurrence of Judge Phillips and Judge Ward.

For the Court,

/s/ John M. Greacen
Clerk